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OVERSIGHT HEARINGS ON THE CONDITION OF U.S. FINANCIAL AND INDUSTRIAL BASE

HEARINGS

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE COMPETITIVENESS OF MANY OF OUR MOST IMPORTANT INDUSTRIES AND MORE GENERALLY ABOUT THE ABILITY OF THE UNITED STATES TO COMPETE EFFECTIVELY IN THE INTERNATIONAL MARKETPLACE DURING THE 1990's; WHETHER THE AMERICAN ECONOMY IS IN DECLINE RELATIVE TO THE NATION'S MAJOR COMPETITORS, AND THE IMPLICATIONS THIS HAS FOR AMERICA'S POSITION IN THE WORLD

JULY 11, 13, 19, NOVEMBER 14 AND 15, 1989

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OVERSIGHT HEARINGS ON THE CONDITION OF U.S. FINANCIAL AND INDUSTRIAL BASE

TUESDAY, JULY 11, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, Sanford, Kerry, Heinz, D'Amato, Gramm, Roth, Kassebaum, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance today. We have going on this week the very sustained and serious effort on the savings and loan conference committee, and so that is involving the committee in a very active way and several members of the committee.

Senator Garn indicated that he is in transit at this particular time and will not be here in time for this hearing but wanted to indicate that he will have a statement for the record and is very much interested in the testimony of the witnesses today.

I think the fact that we are holding this hearing today while the savings and loan effort and the conference is coming to a conclusion is an illustration of how critically important these issues are. And I want to thank our witnesses for their presence today and for the testimony that they will give us.

This committee must reauthorize the Defense Production Act by September 30 of this year, and there is no issue that is more important to this Senator than the competitiveness of all sectors of our economy in the context of today's global environment.

This topic will be a dominant theme of the period of time of my chairmanship and it is my intention to hold a comprehensive series of hearings on these issues throughout the remainder of the Congress. So in some respects, today's hearing will set out a path for us that we will follow in a number of different ways but underscores the importance of our leadoff witnesses in this area.

Over the years, I, along with many others, have become increasingly concerned about the competitiveness of many of our most important industries and more generally about the ability of the United States to compete effectively in the international marketplace. This has serious ramifications not only for our standard of living but clearly for our national defense and our long-term economic and military security.

In 1985, the Council on Industrial Competitiveness established by President Reagan and chaired by John Young, the CEO of Hewlett Packard, warned in that report "that America's ability to compete in world markets is eroding. Growth in U.S. productivity lags far behind that of our foreign competitors." That is a quote from that report. The Council at that time urged the President to take steps to stop the erosion of our industrial competitive position noting that "a strong industrial base is vital to our national security" and made that very direct linkage to national security.

Many of our most responsible chief executive officers and leaders not only share this view but express it with a growing sense of concern and feeling that much more needs to be done to strengthen the underlying position of our economic system and our industrial base as we move into the future and we will be hearing from a number of those business leaders in the months ahead.

Clearly, our competitive position in the world is directly affected by economic and fiscal policies, by education standards, and the planning horizon of many of our corporations. Reputable experts contend that other factors, including the trade practices of some of our major trading partners, also have a direct and vital impact on some of our most important industries and obviously we attempted in part—those of us who serve on the Finance Committee who serve on this committee, Senator Heinz and myself particularly—were involved in drafting the trade bill which is now law as one way of dealing with at least a part of this problem.

Today's focus will be upon our national defense and security interests and more specifically what steps, if any, our witnesses believe that the United States should take to reverse any competitive decline of industries that they see that they believe are essential to our long-term national defense.

We have a truly outstanding panel before us this morning and I want to especially welcome the former Defense Secretary, Frank Carlucci, who gave distinguished service to the country and certainly understands these issues very clearly; former Deputy Director of the CIA, Admiral Bobby Inman; and Dr. Robert Costello.

We are very pleased to have the three of you be able to help begin the process of putting this perspective together for us.

Let me call on my colleague, Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Thank you, Mr. Chairman.

First, let me join you in welcoming Frank Carlucci and Bobby Inman back to Capitol Hill where they've appeared on many occasions in starring roles, and to say that I think these hearings are extremely significant because the debate over the health of the U.S. industrial base really does begin by recognizing the global marketplace is in the throes of convulsive transition.

And while our country is arguably the first among equals, clearly we no longer dominate the trading system in what's become a multipolar economic world. Our large continuing trade deficit and descent into debtor nation status has served to burn into our consciousness the notion that national and economic security interests are fundamentally linked.

Economic security turns on coordinated economic, defense and foreign policies, and preserving, strengthening and coordinating the vital sectors of our economy that make up the defense, industrial and technology base. That means also looking carefully I think at foreign investment and acquisition of defense-related industries, as well as defense and strategic trade exports.

Three recent assessments of the U.S. defense, industrial and technology base project a grim picture of the American economy's ability to support a war effort under current conditions. The first is the Air Force Association's conclusion that the United States and its allies are "not prepared to sustain a conventional war much beyond 30 days and that American industry today could not meet wartime mobilization requirements in less than 18 months."

Second, the Defense Science Board proclaimed that the days of "Fortress America" are over and found that the continued deterioration of the U.S. industrial and technology base has diminished the credibility of our deterrent.

Finally, the Office of Technology Assessment concluded that while U.S. technology, the cornerstone of our security and industry since World War II, has not completely crumbled, nevertheless, foreign companies have made deep inroads into high technology markets that have been the exclusive domain of U.S. industry. OTA also concludes that the United States has become more dependent on foreign sources for defense equipment at a time when technology in defense systems comes increasingly from the civilian sector.

Now if this is a serious problem, someone has to take the blame for it, and I suppose there is more than enough blame to go around. In my judgment, there have been instances of bureaucratic ineptitude. Corruption in the defense procurement system is well known. There have been conflicts between unilateral and multilateral policies and programs. Often there's been an adversarial relationship between industry and government. All of this, I think, has contributed to this state of affairs.

But compounding the shortfalls in U.S. practices is the fact that foreign governments have adopted very consciously policies to ensure that their industries either remain or become innovative and internationally competitive. The best examples are well known. One is EC 1992. Another is Japan's development policies in the field of electronics and looking to the future space and commercial aerospace. A third is Korea's decision to develop a commercial aerospace industry using U.S. technology derived from the so-called United States-Korean Fighter Program. Regarding that United States-Korea agreement to coproduce and improve a version of what I imagine will either be the F-16 or the F-18, I will shortly introduce a resolution urging the President not to make the same mistakes that we made with the FSX. While the FSX and the Korean Fighter Program, dubbed by the media "Son of the FSX," are not entirely similar, they do have one deeply troubling factor in common—the transfer of U.S. aerospace technology to two countries whose avowed goals, whose national stated purpose, is the creation of commercial aerospace industries that will successfully compete with the United States by the end of this century.

Mr. Chairman, I want to take particular note of Senator Dixon's good work in this area. He has developed a set of amendments to the Defense Production Act which I'm pleased to cosponsor, which I hope the committee will move forward on. He has in particular, I'm most pleased to note, included a proposal that I made to encourage domestic procurement at the subcontractor level where much of the technology struggle is being waged. I hope that this hearing will be the next step in turning around the decline of our American industrial base and I look forward to the testimony of our distinguished witnesses this morning.

The CHAIRMAN. Thank you for an excellent statement, Senator Heinz. I would like to insert Senator Garn's statement into the record.

STATEMENT OF SENATOR GARN

Senator GARN. Good morning, I'd like to welcome our witnesses here this morning. Mr. Carlucci, Mr. Inman, Mr. Costello, thank you for joining us. I'm looking forward to hearing your testimony. But let me begin by saying that the purpose of the Defense Production Act, the purpose in 1950 and the purpose as it has been extended since, is to give the President of the United States powers to mobilize the Nation's productive capacity during times of national emergency and, to preserve the defense industrial base during peacetime. The DPA aims to ensure we can mobilize our defense production system when faced with a direct threat to the security of the United States.

While I support extending the current presidential authority as requested by the administration, I hesitate to substantially expand the scope of the act without thorough consideration of the economic ramifications of proposed changes. I hope we will do this as we hold hearings on the competitiveness issue in coming months and as we examine the bill prepared by Senator Dixon and the administration bill. It is important, however, that the committee follow through on its responsibility to extend the basic authority of the act by August 30.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, I commend you for convening this series of hearings begun today. It's important that the committee receive testimony on the ability of America's industrial and technology base to support national defense before undertaking a review of appropriate legislation to reauthorize and strengthen the Defense Production Act.

Reauthorization of the Defense Production Act provides the best opportunity to address some of these important issues. Together with Senator Heinz, who has been a real leader in our battle to improve our Nation's economic might, I will shortly be introducing a bill which provides a broad array of improvements to modernize the act, expanding the reach and enhancing the utility of the authorities presently conferred on the President by the act.

Our Defense Production Act amendments in 1989 will also implement important recommendations of several of the reports completed in the last year, including the Defense Science Board and the

Air Force Association. It also includes provisions calling for the issuance of important acquisition policies designed to foster investment, the development of emerging critical technologies, and access to dependable sources and critical components.

In essence, it will make the Defense Production Act a more effective tool for bolstering the defense, industrial and technology base. It leaves open the question of application of the act's revitalized authorities to specific industries. Such decisions may be addressed by this committee during its deliberations or left to the President.

Mr. Chairman, I again wish to commend you for your leadership on this important item on the committee's agenda for the 101st Congress and I pledge to you my sustained efforts as the committee moves forward.

I ask, Mr. Chairman, consent of the chair and the committee to place a more lengthy statement in the record.

The CHAIRMAN. Without objection, it's so ordered.

[Complete opening statement of Senator Dixon follows:]

STATEMENT OF SENATOR ALAN J. DIXON

Mr. DIXON. Mr. Chairman, I commend you for convening the series of hearings begun today. It is important that the committee receive testimony on the ability of America's industrial and technology base to support national defense, before undertaking a review of appropriate legislation to reauthorize and strengthen the Defense Production Act. I look forward to hearing the thoughtful commentary of the distinguished panels, including both industrial leaders and Government managers who appear before us today, and are scheduled for July 19.

The overall health of U.S. industry, and its competitiveness in world markets, directly affects our ability to meet national defense needs. The defense industrial and technology base are not distinct and separate from our Nation's commercial base. Rather, they are clearly part of that economic whole, sharing weaknesses as well as strengths. Whatever the cause, industry sectors deprived of adequate investment can not be reasonably expected to have efficient production and technological innovation in support of peacetime defense requirements, or production surge in time of emergency.

The steady erosion of the defense industrial base has been a source of deep concern to defense planners for more than a decade. The Defense Science Board reported on its review of industrial readiness plans and programs in November 1976, and found much to be concerned about. A defense industrial base panel created by the House Armed Services Committee conducted 13 days of hearings and compiled a 1,796 page record. The title of the panel's report captures the essence of their findings—"The Ailing Industrial Base: Unready for Crisis". Additional hearings were conducted by the Joint Economic Committee and the Senate Small Business Committee. During the same period GAO was also hard at work—identifying the problems. Yet by 1987, all the GAO could report to the chairman of the Senate Armed Services Committee was that only very limited progress had been made toward the shaping of practical solutions.

And the situation has become more complex with the passage of a decade. America is now clearly part of a global economy, facing increasingly strong competition from Japan, Korea, and Europe. The defense industry has become more interdependent, in terms of both technology and trade in products, from individual components to complete systems. You can point to the benefits of such defense trade with our NATO allies and other trading partners, in economic as well as strategic terms.

But such interdependence is not without risk or cost. Many items of our military hardware are becoming increasing dependent upon the products of foreign suppliers, and the extent of such dependence remains essentially unknown. In addition, strong arguments are made that the nurturing of certain fundamental industrial and technological capabilities may be even more vital to both our long-term national economic wellbeing as well as our national defense.

During the last Congress, attention was again focused on the defense industrial and technology base. I introduced S. 1892, the "Defense Industrial Base Preservation Act of 1988". The DOD Authorization Act for fiscal year 1989, Public Law 100-456, included a series of defense industrial and technology base provisions, many drawn from S. 1892. In particular, with respect to defense industrial base matters, the responsibilities and authorities of the Under Secretary of Defense for Acquisition were specified. Even without the support of that legislation, Bob Costello exercised his usual enthusiastic leadership qualities to make revitalization of the base a priority issue during his tenure in that post. "Bolstering Defense Industrial Competitiveness" laid the foundation for future action, if future leaders at the Pentagon, and elsewhere in the Government, want to carry forward.

The Defense Science Board also revisited the issues in light of the new realities. It recommended White House-level attention to the interplay between defense planning and broad Government economic policies, with a clearer voice for the Defense Department. At the same time, it recognized that there had to be an equally high level forum to undertake the rationalization of national defense planning and the capabilities of industry to fulfill those plans, both in peacetime and in conflict. The Defense Science Board recognized the need to provide incentives for investment in modern manufacturing facilities, equipment, and processes, through changes in corporate thinking as well as changes in Government acquisition policy.

Additional analyses were conducted by the Air Force Association (AFA), the Office of Technology Assessment (OTA), and the Center for Strategic and International Studies (CSIS). Again, the titles of their respective reports capture the flavor of their overall findings: "Lifeline in Danger" (AFA), "Holding the Edge" (OTA), and "Deterrence in Decay" (CSIS).

A "Wake Up America" coalition has even been formed. This group led by the American Electronics Association, the National Center for Manufacturing Sciences, and Rebuild America is advocating the concept of industry-led, Government-supported consortia to revitalize America's strategic industries and manufacturing technologies.

Mr. Chairman, the reauthorization of the Defense Production Act provides the best opportunity to address some of these important issues. Together, Senator Heinz, who has been a real leader in our battle to improve our Nation's economic might, I will shortly be introducing a bill which provides a broad array of improvements to modernize the act, expanding the reach and enhancing the utility of the authorities presently conferred on the President by the act. Our "Defense Production Act Amendments of 1989" will also implement important recommendations of several of the reports just noted, including the Defense Sciences Board and the Air Force Association. It also includes provisions calling for the issuance of important acquisition policies designed to foster investment, the development of emerging critical technologies, and access to dependable sources of critical components.

In essence, it will make the Defense Production Act a more effective tool for bolstering the defense industrial and technology base. It leaves open the question of application of the act's revitalized authorities to specific industries. Such decisions may be addressed by this committee during its deliberations, or left to the President.

Mr. Chairman, I again wish to commend you for your leadership on this important item on the committee's agenda for the 101st Congress, and pledge to you my sustained efforts as the committee moves forward. I look forward to today's testimony from such a distinguished panel of witnesses.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, let me first say that we all share a concern about the U.S. industrial base. I think there is a very sharp difference of opinion, however, as to how we can strengthen that base.

If Government intervention, if central economic planning, was the path to take in strengthening the industrial base and increasing the military might of the Nation, Ivan would have knocked down the gate long ago and freedom would have been lost in Western Europe, here and all over the world.

In truth, the Defense Production Act that has kept Ivan back from the gate, that has created a wealth machine in South Korea, which had a per capita income of $50 a year in 1953 and now has a per capita income of $3,500 a year and is the 7th largest spender on defense in the world, that has literally changed the balance of power in this world—the real Defense Production Act in America is called the American free enterprise system and free trade.

I believe, Mr. Chairman, that the Defense Production Act is a very valuable tool to be used in a period of mobilization or in a period of international conflict. I think, however, it is a very dangerous law with sweeping powers that would allow a President literally to wreck the American economy with the extension of controls, subsidies and interferences with the fundamental working of the market.

I believe that there are some technologies that are new and exciting, technologies that should be looked at as part of our defense research effort, but I think any effort to try to manipulate the economy, to try to pick winners and losers in terms of investment and economic growth, is destined to be counterproductive and is destined to be a failure. And I might remind my colleagues of the words of our former chairman, Senator Proxmire, on the subject. In talking about whether, in the process of setting economic policy, resources would be allocated by politics or economics, Senator Proxmire said, in his usual wisdom on this subject, "Money will go where the political power is. Anyone who thinks Government funds will be allocated to firms according to merit has not lived or served in Washington very long."

I submit, Mr. Chairman, that it is very important that we be careful in our zeal to improve the productive power of the American economy to look at what is happening in the world. I never cease to be amazed at the fact that all over the world we hear terms like perestroika, restructuring, competitiveness, uttered in Russian, in Chinese and in Spanish, and yet those words and those concepts hardly ever penetrate the thick walls of the U.S. Capitol. It always amazes me, in this great bastion of free enterprise and economic freedom, that there are so few voices to speak for the concept that is literally winning the cold war and that is literally liberating the people of Central Europe, the concept that has brought a legitimate debate, which has turned violent unfortunately but has awakened the spirit of freedom and democracy in China, and is literally changing the political landscape even in the Soviet Union.

Why we are so determined to model our policy after policies that do not work, that are failing our adversaries, that have never worked in history, I never ever cease to be amazed. But this is an ongoing education process, both for me and the Nation, and I welcome the opportunity to debate this bill.

I believe there should be fundamental reform in the Defense Production Act. I suspect my views are in the minority, but I believe the bill gives the President too much power. We have been blessed as of late with enlightened Presidents. I hope we will always be blessed with enlightened Presidents, but there is no guarantee that we will be. I think giving the President of the United States massive unilateral power in peacetime to allocate resources, to pick winners and losers in the process of investment and economic growth, is a very dangerous policy. I think our efforts in this area should be limited to research. I think development should be done in the private sector of the economy, and I think all that we see happening in the world argues for this viewpoint.

I thank you, Mr. Chairman.

The CHAIRMAN. I would like to say before calling on our first witness that with the United States having now led the Western Alliance certainly since World War II, shared responsibility but our country being in the lead, it's an enormous responsibility and it's a very expensive responsibility and it's not easy to carry out when you, as a nation, represent 4 percent of the world's population, as we do. So the question of how we make sure that we are able to defend ourselves and defend our interests and values around the world is a very sober and heavy responsibility and we could not have better witnesses to address that question.

So let us begin with former Defense Secretary Carlucci, who now serves as vice chairman of The Carlyle Group based here in Washington, DC. We would be very pleased to hear from you now.

STATEMENT OF FRANK CARLUCCI, VICE CHAIRMAN, THE CARLYLE GROUP, WASHINGTON, DC, FORMER SECRETARY, DEPARTMENT OF DEFENSE

Mr. CARLUCCI. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, it's a pleasure to appear before you today on this important subject. It's a subject that I have been concerned about for some time and I might note that the Defense Science Board study that both Senator Heinz and Senator Dixon referred to was undertaken at my personal initiative shortly after I got into the DOD.

CAPABILITY TO SUPPORT OUR NATIONAL SECURITY

Let me open this up by addressing the four questions posed in your letter of invitation. First, let me state an underlying theme of my testimony. That theme is that the capability of our industrial base to support our national security is a function of the overall strength of the U.S. economy and not of just the defense contracting base.

The Department of Defense plays a major role in this economy and both as a consumer of output and as a sponsor of advanced research and development. DOD has undertaken many initiatives recently to remedy industrial weaknesses within its control, but at the same time, there are critical weaknesses in the budgeting and programming system which have impacted adversely on our defense industrial base. Nonetheless, most of the capabilities and responsibilities to ensure a strong defense industrial base lie outside DOD's immediate control. It's important that we look beyond DOD in dealing with this subject.

In response to your first question concerning the industries that must be maintained to ensure industrial strength, my simple answer is that most manufacturing industries contribute to our national defense. Every major weapons system contains tens of thousands of parts whose production touches virtually all sectors of our economy either directly or indirectly.

If importance is measured simply in terms of what it takes to produce superior weapons systems, I would be hard pressed to identify many sectors of the economy that we could do without.

The importance of manufacturing strength across the board is reflected in the highly interdependent nature of production capabilities in today's world. When we let our production capabilities deteriorate in one area and become dependent on foreign suppliers, we run enormous risk of falling behind and becoming dependent in other areas as well.

Obviously, the risk is greatest in areas where technology is changing rapidly, but most mature industries are also important building blocks to manufacturing, technological and scientific leadership.

For example, even while we are pursuing new materials development to meet the everincreasing demands for better performance, we cannot afford to become dependent on foreign suppliers for steel and other basic materials.

The fact is that we cannot retain manufacturing, technological and scientific leadership based on industrial strategies of high-tech boutiques. Not only will these boutiques fail to meet many of our basic needs, they will eventually be overwhelmed financially and technologically by foreign competitors.

INDUSTRIES IN COMPETITIVE DECLINE

Turning to your second question, you've asked me to identify U.S. industries that are in competitive decline. Again, my response—perhaps oversimplified—is that we are experiencing a competitive decline across the board. In a recent study of 22 key technologies that the Congress mandated in the Defense Authorization Act, you can see in at least 5 categories, if my memory serves me correctly, where Japan exceeds the United States. But it's important to bear in mind that our decline is relative, not absolute. Our manufacturing, technological and scientific capabilities are constantly improving, but so are those of our international competitors. We're not getting worse. Other countries are getting better.

In this respect, let me identify what I believe is a key issue—U.S. access to foreign technology. The trade deficits we have run in recent years and concerns about our defense production capabilities have strengthened protectionist sentiment on Capitol Hill. I would caution against a shift in the protectionist direction, not just for economic reasons, but for technological reasons as well.

If we protect U.S. industries from foreign competition, we reduce the incentive to invest in modern facilities and advanced technologies and we deprive ourselves of access to advances in technology being achieved in other countries. We also invite retaliation. It could be disastrous to our national security if we assume we can go it along technologically.

This point leads me to the third question concerning our competitive decline. One major cause has been U.S. complacency and the failure to recognize the changing nature of the world economy. Complacency was bred by the fact that U.S. manufacturing was so far ahead of the rest of the world in both technology and productivity for so long, we failed to recognize the growing competitive challenge and to adjust our ways of doing business.

We were also quite late in going global. Indeed, a number of companies still resist this concept. We suffered industrial hardening of the arteries, resulting from inflexible manufacturing processes, poor quality control, inattention to customer service, failure to design for producibility, and the short-term horizon of management, driven in part by the takeover trend and by an increasingly litigious society. We also suffered from the Government's negligence of U.S. industry. In areas such as taxes and trade, our Government has been slow to adapt to the competitive challenge from abroad.

In addition, the instability of defense funding and the effort to squeeze every last dollar from the contractors in the name of competition have reduced the ability of that industry to raise capital for R&D investment and have driven many companies out of the defense business. It's a false economy to drive defense profits down to the point where companies cannot raise money in the capital markets for investment. Low P/E ratios have also helped to fuel the foreign takeover of U.S. defense contractors. Adequate risk-reward ratios are essential for a healthy industrial base. Today, these are out of line.

I come to the committee's final question concerning measures to ensure a competitive U.S. industrial base.

NEED FOR NEW CONCEPTS IN MANUFACTURING

First, we must find ways to encourage more rapid adoption of new concepts in the manufacturing process. For example, the Pentagon is promoting total quality management and concurrent engineering. The former recognizes the economic advantage in doing something right the first time so you don't have to do it over and over again. Such companies as Westinghouse, on whose board I serve, has made impressive strides in this area. The latter recognizes that it is foolish to design products without taking into account such considerations as producibility, reliability, and maintainability.

The Government should take a more active role in encouraging adoption of improved manufacturing processes throughout our industrial base and not just among defense contractors.

The Department of Defense also has a manufacturing technology program to encourage development of advanced manufacturing processes and the industrial modernization incentives program to promote greater investment in cost-savings measures. More favorable tax policies should be considered, as should some means of funding investments in manufacturing capabilities.

Finally and most important, we should adopt long-term funding in our defense programs. This is critical to industries' ability to modernize and economize.

Mr. Chairman, I am one who believes we can compete in the world scene, but only if we rise to the challenge by rejecting protectionism, going global, and putting our noses to the grindstone.

Industry has to do this, as Senator Gramm said. But Government can help by providing the incentives. DPA can be a valuable tool in stimulating industry in critical areas.

I commend you on your initiative in reviewing and seeking to strengthen it.

Thank you.

[The complete prepared statement of Mr. Carlucci follows:]

STATEMENT BY FRANK C. CARLUCCI
BEFORE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
July 11, 1989

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today in my new role as an outsider looking in. This role finds me no less concerned about U.S. industry and our national security.

Let me address the four questions posed in your letter of invitation. First, however, let me state an underlying theme to my testimony. That theme is that the capability of our industrial base to support our national security is a function of the overall strength of the U.S. economy, not just the strength of our defense contracting base. The Department of Defense plays a major role in this economy both as a consumer of output and a sponsor of advanced research and development. DoD has undertaken many initiatives recently to remedy industrial weaknesses within its control; at the same time, there are critical weaknesses in the DoD-Congressional programming and budgeting process that have contributed to the erosion of our industrial base. But, most of the capabilities and responsibilities to ensure a strong defense industrial base lie outside DoD's immediate control. It is important that we look beyond DoD and focus more on national solutions.

In response to your first question concerning the industries that must be maintained to ensure U.S. industrial strength, my simple answer is that most manufacturing industries contribute to our national defense. Every major weapon system contains tens of thousands of parts, whose production touches virtually all sectors of our economy either directly or indirectly. If importance is measured simply in terms of what it takes to produce superior weapon systems, I would be hard-pressed to identify many sectors of our economy that we could do without.

The importance of manufacturing strength across the board is reflected in the highly interdependent nature of production capabilities in today's world. When we let our production capabilities deteriorate in one area and become dependent on foreign suppliers, we run enormous risks of falling behind and becoming dependent in other areas, as well. Obviously, the risk is greatest in areas where technology is changing rapidly, but most mature industries are also important building blocks to manufacturing, technological, and scientific leadership. For example, even while we are pursuing new materials development to meet the ever increasing demands for better performance, we cannot afford to become dependent on foreign suppliers for steel and other basic materials.

The fact is we cannot retain manufacturing, technological, and scientific leadership based on an industrial strategy of "high-tech boutiques." Not only will these boutiques fail to meet many of our basic needs, they will eventually be overwhelmed financially and technologically by foreign competitors.

Turning to your second question, you have asked me to identify U.S. industries that are in competitive decline. Again, my simple response is that we are experiencing competitive decline across the board. But the decline is relative, not absolute. Our manufacturing, technological, and scientific capabilities are constantly improving, but so are those of our international competitors. We are not getting worse; other countries are getting better.

In this respect, let me identify what I believe is a key issue: U.S. access to foreign technology. The trade deficits that we have run in recent years and concerns about our defense production capabilities have strengthened protectionist sentiments on Capitol Hill. I would caution against a shift in the protectionist direction not just for economic reasons, but for technological reasons as well.

If we protect U.S. industries from foreign competition, we reduce the incentive to invest in modern facilities and advanced technologies, and we deprive ourselves of access to advances in technology being achieved in foreign countries. We also invite retaliation. It could be disastrous to our national security, if we assume we can "go it alone" technologically.

This point leads me to the third question concerning the causes of the competitive decline of U.S. industries. One major cause has been U.S. complacency and the failure to recognize the changing nature of the world economy. Complacency was bred by the fact that U.S. manufacturing was so far ahead of the rest of the world in both technology and productivity for so long. We failed to recognize the growing competitive challenge and to adjust our ways of doing business. U.S. industry was too late in going "global." Indeed, some still resist this concept.

We suffered industrial hardening of the arteries resulting from inflexible manufacturing processes, poor quality control, inattention to customer service, failure to design for producibility and the short term horizon of management driven in part by the takeover trend and an increasingly litigious society. We also suffered from the government's negligence of U.S. industry. In areas such as taxes and trade, our government has been slow to adapt to the competitive challenge from abroad. In addition, the instability of defense funding and the effort to squeeze every last dollar from the contractors in the name of competition have reduced the ability of that industry to raise capital for R&D investment and have driven many companies out of the defense business. It is a false economy to drive defense profits down to where companies cannot raise funds in the capital markets. Low P/E ratios have also helped fuel foreign takeovers of U.S. defense contractors. Adequate risk reward ratios are essential for a healthy industrial base. Today, these are out of line.

I come to the Committee's final question concerning measures to ensure a competitive U.S. industrial base. First, we must find ways to encourage more rapid adoption of new concepts in the manufacturing processes. For example, the Pentagon is promoting total quality management and concurrent engineering. The former recognizes the economic advantages in doing something right the first time so you do not have to do it over and over again. Some companies such as Westinghouse on whose board I serve have made impressive strides in this area. The latter recognizes that it is foolish to design products without taking into account such considerations as producibility, reliability, and maintainability. The government should take a more active role in encouraging adoption of improved manufacturing processes throughout our industrial base, not just among defense contractors.

The Department of Defense also has the Manufacturing Technology Program to encourage development of advance manufacturing processes and the Industrial Modernization Incentives Program to promote greater investment in cost-saving measures. More favorable tax policies should be considered, as should more direct means of funding investments in manufacturing capabilities. Finally and most important, we should adopt long term funding in our Defense programs. This is critical to industry's ability to modernize and economize.

Mr. Chairman, I am one who believes we can compete on the world scene, but only if we rise to the challenge by rejecting protectionism, going global and putting our noses to the grindstone. Industry has to do this, but government can help by providing the incentives. The DPA can be a valuable tool in stimulating industry in critical areas. I commend you on your initiative in reviewing and seeking to strengthen it.

The CHAIRMAN. Thank you very much.

Mr. Inman, let's hear from you now, please.

STATEMENT OF B.R. INMAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, WESTMARK SYSTEMS, INC.; FORMER DEPUTY DIRECTOR OF THE CIA

Mr. INMAN. Mr. Chairman, if I may, I would like to submit a statement for the record which specifically responds to the questions.

The CHAIRMAN. We will make that a part of the record.

Mr. INMAN. I came really to support Dr. Costello, so I want to save most of the time for what he's got to say today, but the opening comments triggered some responses, if I may.

I spent 30 years of my life looking intensely at the outside world. I've now been privileged to have 7 years to intensely look at my own country. How we compete in the international marketplace has been at the center of my interest for those 7 years.

My business activities—4 years running a research and development consortium, 2½ years running a holding company buying electronics firms—have given me an opportunity to look at how business now functions. The Business/Higher Education Forum, the Council on Competitiveness, and the Carnegie Commission on Science, Technology and Government have given me opportunities to look in different areas.

Let me suggest to you that for this country to be competitive we must have reliable sources of capital at competitive rates, and as long as we have interest rates that are double those of competing countries we will not be competitive in the international marketplace.

We have to have a skilled and motivated work force and for me that says education at all levels is the front line of this ability to compete.

Given the standard of living we wish to sustain, we must have higher levels of productivity than any other country in the world or we won't sustain that.

QUALITY FORGOTTEN FOR MANY YEARS

Quality is the absolutely essential ingredient that we forgot for many years. If we do not have quality across the board, all kinds of efforts to open trade boundaries will not result in balance of payment changes as long as there is a perception that American products are not of comparable quality. I simply refer to the continued level of imports, as the American consumers vote with their pocketbooks for the products they judge to be of better quality.

There has to be a strong science and technology base. There, we still have the best news of U.S. lead, even though in many areas there is clearly a sign of decline.

Government sets the environment in how all of these activities transpire, and I realize that now from these past 7 years far more clearly than I did in the previous 30.

As I watched with great interest Dr. Costello's efforts these last 2 years, I strongly applauded from the sidelines the effort to bring a renewed focus on the defense industrial base. DOD is the Government's largest customer and the practices they institute at the marketplace set the environment for much of our competitiveness. I like to believe I exercised prudence in using we taxpayers' dollars for 30 years. Now for 7 years I have been using other people's money in the private sector. I find at the commercial marketplace that with a focus on state-of-the-art materials, state-of-the-art manufacturing and unremitting quality, I can provide a handsome return for my shareholders. At the defense marketplace, none of those apply. And in retrospect, I would have been better off 2½ years ago to put the dollars entrusted to me for the defense marketplace into Treasury bills as opposed to defense production activities.

[The complete prepared statement of B.R. Inman follows:]

STATEMENT

BY

B. R. INMAN
Chairman and Chief Executive Officer
Westmark Systems, Inc.

Before

The Committee on Banking, Housing,
And Urban Affairs

of the

United States Senate

July 11, 1989

There is good reason to be concerned about erosion of our nation's defense industrial base. We are becoming increasingly dependent on foreign sources for critical materials and equipment, while at the same time U.S. suppliers depart from the defense marketplace. The time required to design and produce weapon systems has increased significantly, and our ability to sustain our involvement in conflict is no longer certain.

Among the many reports documenting a decline in the U.S. defense industrial base is an excellent report from the Center for Strategic and International Studies. The report makes a clear and thoughtful statement about the role of the defense industrial base in our national security strategy, identifying three fundamental contributions: peacetime efficiency, technological competitiveness, and crisis flexibility. We are in danger in all three of these areas, and immediate action is justified.

However, I believe that the steps necessary to address the problems of our nation's defense industrial base go well beyond the intent and purpose of the Defense Production Act. We must be careful, in reauthorizing the Act, not to confuse symptoms of a much deeper dilemma facing our national security system.

A requirement, such as the one in House legislation currently under consideration, that all items critical to our national defense be provided exclusively by domestic providers within a specified period of time is an unwise approach. Instead, the package of increased incentives, improved analytic capabilities, and domestic preference provisions represent a reasonable package of policy options. The amendments, in conjunction with other related changes in our national strategy and defense management efforts, could significantly contribute to improving the health of our defense industrial base.

The letter of invitation to speak before the Committee today included four questions. I will deal only briefly with the first two questions, and focus my intention instead on the roots of our defense industrial base erosion and steps we should take to address the problems.

The first two questions asked are which industries are critical to our nation's defense and whether we are in a competitive decline in any such industry.

There have been numerous studies to guide the Committee and Congress in this first question. Private organizations such as the National Academy of Sciences have produced excellent analyses of emerging technologies, focusing on industries such as telecommunications, materials science, microelectronics, and others. Even more relevant to our national security, each of the services have produced their own key technologies lists as a way of guiding their RDT&E programs. Recently, the Aerospace Industries Association produced its list of key technologies of the future, and other trade and professional associations have done the same.

If there has been any weakness, up until now, it is the proliferation of such lists with relatively little coordination. Last year's Defense Authorization Act, in which Congress included a new provision requiring the Department of Defense and the Department of Energy to jointly produce a critical technologies plan, was an important step toward better analyses. This year, the first critical technologies plan was released, identifying 22 technologies which DOD and DOE consider critical to our future national security. While there were some weaknesses with the plan, the Departments have been working closely with Congress to improve the quality of the document.

This focus on "technologies" does not necessarily translate into identification of critical industries. Therefore, last year's Defense Authorization Bill also included provisions giving the Undersecretary of Defense for Acquisition responsibility for providing overall policy guidance and direction to the military departments and the defense agencies on matters relating to the maintenance, expansion, and readiness of the defense industrial base of the United States.

The responsibilities were included in Chapter 148 of the Authorization Bill in a new section entitled "Defense Industrial Base," which includes several requirements for analyzing and evaluating U.S. capability to meet mobilization and critical equipment requirements. The analyses required in the section are to be completed by September 30, 1990, and to be reported to the Armed Services Committees of the Senate and House by February 1, 1991. The information in these reports will also be critical to this Committee in its responsibility to carry out programs under the auspices of the Defense Production Act, and effective coordination between all involved committees will be essential.

One concern deserves a brief mention at this point. Each of the various committees which touch the defense management system impose their own set of reporting requirements on the department. As new reporting requirements are imposed, consideration should be given to existing reporting requirements and potential overlap or duplication which might be occurring. I have no information as to the extent of the problem, but a joint committee review could determine the extent of the problem.

We are clearly seeing a significant erosion in our ability to provide critical equipment and materials in several important sectors. My own experience has been primarily with the computer and electronics industry. There has been much publicity about the loss of worldwide market share in semiconductor devices. Major national efforts are underway here in the United States to try to recapture our competitiveness in these industries, but these efforts have been instituted only after foreign domination was imminent. Not only are semiconductor devices themselves increasingly foreign provided, but the equipment used to produce semiconductor devices is dominantly of foreign origin. There is only one domestic supercomputer manufacturer remaining, and while the U.S. is still the leader in personal computers and software products, there is substantial growth in foreign successes in these critical areas.

Some of the most compelling statistics in the report from the Center for Strategic and International Studies dealt with the decline of domestic sources of production. For example:

0 In 1982, over 118,000 firms provided goods to DOD in 215 critical defense sectors, accounting for 90% of all DOD purchases. By 1987, the number shrunk to only 38,000. Thus, over 80,000 suppliers left the defense marketplace during the 1982-1987 period.

0 This occurred despite the increase in dollars allotted to defense procurement and a significant increase in the number of firms providing goods to all buyers. This fact led CSIS to conclude that "firms in critical defense sectors are leaving or avoiding the defense business in favor of more profitable endeavors elsewhere."

0 More than 280 product groups lost producers between 1982 and 1987, including the following specific examples: More than 4,000 firms left the airframe structural components business; more than 600 firms left the anti-friction bearings business; 890 of 1310 firms no longer sell powered valves to DOD; and 668 of 834 businesses stopped supplying navigational instruments.

Therefore, perhaps the most important message I have to offer today is one that may seem obvious. While we must address significant erosion in the supply of specific items, our actions should focus less upon specific products and technologies than the problems at the root of our defense industrial base erosion.

The roots of this problem can be traced to several trends. Among those I believe to be most important are:

1. The globalization of the international economy;
2. Significant changes in our national military strategy;
3. The difficulties of selling to the defense marketplace; and
4. Deficiencies in our process of technological innovation.

Allow me to address each of these briefly.

First, the globalization of our economy has received a great deal of attention in recent years. An article in the July 3rd Wall Street Journal pointed out that the U.S. now accounts for just over 10% of world trade in manufacturing. This is down from 13% in 1980 and 15% in 1970. While some of the slippage can be attributed to problems in U.S. industrial competitiveness or to currency exchange rates, a great deal can also be attributed to the increasing competitiveness of industrialized and newly industrialized nations.

Nor should we overlook the fact that innovation is increasingly occurring on a global basis. In 1963, foreigners received just under 20% of patents filed in the United States. In 1988, that number had risen to 48% of the patents issued in this country.

Recognition of our competitiveness problems has caused us to seek ways to increase productivity and investment, and our actions are beginning to bear fruit. However, in many of our key industries, products -- both civilian and military -- are now available more cheaply and at higher quality from foreign suppliers. Out of 122 defense sectors analyzed in the CSIS report, import penetration grew significantly in 104 sectors between 1980 and 1986. We must accept foreign sourcing as a fact of life, since we do not wish to deny ourselves the best product at the best price.

However, this is a trend which must be monitored closely. We cannot permit ourselves to be caught short in times of national crisis. Nevertheless, there does not currently exist a systematic method for assessing import dependency in critical items. This was noted in at least two of the major reports on the defense industrial base:

0 The CSIS report concluded that "no service has a complete set of analyses on the ability of the defense

industry to supply its needs for future conflict situations."

0 The report by the Undersecretary of Defense for Acquisition entitled Bolstering Defense Industrial Competitiveness, concluded "the Department of Defense does not know the extent to which foreign-sourced parts and components are incorporated in the systems it acquires. There is no systematic, established means to identify foreign-sourced parts and components and hence no way to determine the extent of foreign dependencies or vulnerabilities."

We must improve our analytic capabilities in order to do as the Undersecretary of Defense for Acquisition's report proposed and provide "visibility of critical foreign-sourced items."

But the implication of economic globalization goes well beyond the availability of specific items critical to our national security. The ability of the U.S. to compete is itself a critical issue in our future national security. The U.S. must recognize that economic preeminence is equally important as military superiority.

In this regard, the recommendations offered by some to designate the Secretary of Defense as a member of the Economic Policy Council and establish a Defense Working Group within the President's Economic Council are timely and appropriate.

I suggest as a corollary action appointment of the Secretary of Commerce to the National Security Council when international trade matters are under discussion. This is particularly important given the increasing role for the department in the evaluation and reporting of offsets and memoranda of understanding which the proposed amendments to the Defense Production Act would require.

The second trend is the fundamental change underway in our national military strategy. The changing nature of superpower relations is one of the most significant occurrences of our time. Improved relations with the Soviet Union could potentially lead to major changes in our force structure in Western Europe and elsewhere. Meanwhile, the probability of low intensity regional conflicts becoming the predominant form of military confrontation will require that we stress rapid response and deployment, with an emphasis on conventional, and even low-tech, weapons.

We must be careful not to become caught in a euphoric response to improved superpower relations, however. Political evolution also increases political volatility, as we have most recently seen in the troubling events that have taken place in China. Thus, it is critical that we maintain a strong foundation for flexible response.

A major difficulty occurs in the disconnect between planning of our national military strategy and acquisition of major weapon systems. Once again, this problem was recognized in last year's Defense Authorization Bill. The Bill's section 732 requires that the Secretary of Defense and the Joint Staff better define the links between national military strategy and specific acquisition programs. The section requires the Secretary of Defense to commission an independent study to assess the degree to which the development and acquisition of weapon systems is currently linked to and determined by the national military strategy and to recommend improvements where necessary or desirable. Once again, the results of this study should be of great interest to this committee and could potentially prove extremely important in identifying problems in our defense industrial base.

Combining the impact of these first two issues together -- the national security implications of economic globalization and the changing nature of our military strategy -- there emerges a unique and crucial challenge for the United States. No other nation is a predominant player in both economic and military confrontations. Only the United States faces the dual challenge of maintaining its preeminent economic position and supporting significant military obligations. We must not be forced to make a choice between these two. Instead, we must effectively coordinate our economic and military strategies in order to sustain our effectiveness in the face of both sets of challenges.

One implication of this is that we can no longer afford the separation of defense and commercial production unless it is absolutely essential. By increasing the use of commercial products to meet defense needs, increasing dual use technologies, and encouraging joint military/civilian production lines, we can contribute to the health of the commercial economy as well as strengthen the defense industrial base. This can only be done, however, if the costs and inefficiencies which currently plague the system are not passed along to commercial companies with whom the government seeks to do business.

The third area of concern particularly troubles me. The management of our defense acquisition process has become increasingly complex and adversarial. While I have no data to support my statement, I would venture that the departure of U.S. suppliers from the defense marketplace is caused as much by an attempt to avoid the complexities of the defense procurement system as it is by an inability to compete in an international competitive marketplace.

Several recent studies have assessed the extent to which reforms proposed by the Packard Commission have been adopted by the Department of Defense. Most encouraging, the management review which Secretary of Defense Cheney recently submitted to the White House will reportedly accelerate the implementation of many Packard Commission reforms, although early reports indicate the Secretary's recommendations may generate substantial controversy.

At the same time, new procurement requirements currently being adopted are increasing the complexity for contractors attempting to respond. For example, requirements promulgated by the Office of Federal Procurement Policy under the auspices of Title VI of its Reauthorization Act will require that contractors certify that no employee had access to source selection information during the process of preparing a response to a procurement. While this does not appear troubling on its face, lengthy discussions between industry and federal procurement officials, as well as testimony before Congressional hearings, have indicated that there is no uniformity in the definition of source selection information among the services and the implementation of these requirements may differ from procurement to procurement. It is this kind of fragmented and inconsistent acquisition policy that leads U.S. suppliers to abandon the U.S. defense marketplace.

While it is certainly true that abuses such as those uncovered in the "Ill Wind" investigations must be promptly and decisively addressed, responding with excessive regulation could be far more harmful to the health of the U.S. industrial base than the act which prompted the response.

There are many other equally important areas:

0 As we more effectively coordinate our national military strategy and acquisition requirements, we have an opportunity to increase stability in our defense budgeting. We should increase the use and availability of multi-year plans and budgets.

0 We must continue the trend to consider quality in our competitive procurements as well as price.

0 We must simplify military specifications in order to increase our ability to employ commercial products to the extent possible in meeting our military requirements.

0 We must maintain our program of Independent Research and Development, even in the face of competing budget requirements.

These are just a few of the many reforms that have been recommended over the last few years by analysts and critics from all segments of our defense industry -- public, private and academic. We know that problems exist, and we have a fairly firm notion of the solutions. What is required is decisive action to implement the solutions.

A major objective of our actions must be to reduce the cost of doing business for firms involved in supplying defense industrial needs. The CSIS Report I referred to earlier includes a cogent analysis of the importance of this objective:

> "The basic reason for the erosion of the defense industrial base in the 1980's is rooted in the very structure of the base. Most sectors in which the DOD does business are highly competitive markets and the DOD is a small customer. Most defense related industries are commercially driven. Acquisition policies that add to the cost of doing business with the DOD cause firms in these sectors to move toward more profitable, less risky commercial customers."

A fourth area of concern relates to difficulties in the creation and insertion of advanced technologies into our defense products. A recent report by the Office of Technology Assessment entitled Holding the Edge: Maintaining the Defense Technology Base provides an excellent overview of this problem. The report discusses weaknesses in the management structure for technology base, the management of DOD laboratories, technology acquisition, and defense/commercial interdependence.

Each of these are issues which deserve attention in the management of our technology base programs.

Improvement of our technology base, however, goes beyond the identification and development of advanced product technologies, and must also include the development of advanced process technologies. A national commitment to manufacturing modernization and excellence is critical to military and civilian capabilities.

Addressing the implications of these four trends requires effective coordination among the Armed Services Committees, the Budget Committees, the Appropriations Committees, and committees with oversight of the Defense Production Act as well as technology and trade issues. In short, the agenda implied by the problems of our defense industrial base is broad and multifaceted.

Thus, the structure and complexity of Congressional oversight can become a disruptive aspect of the system. In a report addressing a somewhat different, but related, issue produced by the Council on Competitiveness, a similar problem was noted in the Congressional oversight of our Science and Technology Policy. The report noted that in Congress, the civilian science budget is divided among nine of the thirteen different appropriations committees. Defense appropriations are more focused, but, as I previously noted, responsibility for various aspects of the defense process are spread across multiple committees. Therefore, some Congressional attention should be given to clarifying the delegation of responsibilities among committees and seeking ways to simplify and clarify the role of Congress.

Permit me to turn my attention now, however, to some specific provisions I am aware are being discussed.

First, expansion of incentives under Title III. Such incentives can be important tools for increasing domestic suppliers of threatened items or encouraging suppliers to reenter abandoned markets. In the case of incentives, however, it is important that the incentives not only be authorized but also appropriated. The CSIS Report noted that "the FY 1987-1989 budgets authorized by Congress (under Title III of the Defense Production Act) provided $150 million for (incentive programs), but in FY 1988, only $27.5 million was appropriated for that purpose."

Second, broadening anti-trust immunities under Title VII is also an effective tool. The model which could be used is the National Cooperative Research Act which has encouraged the creation of research and development consortia and is currently the focus of several bills expanding anti-trust protections to include joint manufacturing and related activities. One important section of the National Cooperative Research Act is the so-called Rule of Reason clause. This requires that whenever an action is taken against a consortium for anti-trust activities, the pro-competitive benefits be weighed against the damages resulting from the consortium's activity as the ruling officer comes to a determination in the case.

Finally, proposals which would encourage investment in advanced manufacturing technologies also have the potential to yield great benefits. Any steps which Congress can take to encourage or give preferential consideration to companies modernizing facilities and production systems will pay off handsomely in an improved industrial base.

I also strongly support limiting the use of domestic-only suppliers to specific items, rather than broad domestic-only requirements, and preference of the use of domestic suppliers as a factor in evaluation for procurements.

Finally, I suggest that the recommendations included in the Defense Science Board's Defense Industrial and Technology Base Report of 1988 regarding surge capabilities be incorporated into any bill. The recommendations integrating surge capability planning into the acquisition process by the Joint Chiefs of Staff or the Services choose high priority surge items for selective funding. The Report also recommended a purchase of an 18 month buffer stock for work in process to cover critical foreign-sourced components. Finally, the report suggested defining quantitative, objective criteria for commencing industrial surge in times of national emergency.

Once again, I appreciate the opportunity to appear before the Committee today. I especially appreciate the invitation to address such a wide ranging set of issues, and I congratulate you on your efforts to take positive actions to improve the critical defense industrial base of our nation.

The CHAIRMAN. I'm anxious to come back to some of the points that you've raised.

Dr. Costello, let us hear from you now.

STATEMENT OF ROBERT B. COSTELLO, HUDSON INSTITUTE, FORMER UNDER SECRETARY FOR DEFENSE

Dr. COSTELLO. I trust we're all going to come back to some of the points that have been raised.

Mr. Chairman, I appreciate being here today because one of the first things that I did when I took on the assignment of Assistant Secretary of Defense and then finally as Under Secretary of Defense was to concentrate on the defense industrial base. We put a report together, submitted to Secretary Carlucci last June, "Bolstering Defense Industrial Competitiveness," which is one of the key issues as we look at the Defense Production Act.

It was the first time the Department of Defense had put down a series of options to ensure the necessary production base for a wide variety of the defense needs that Secretary Carlucci had looked at.

Times have changed since the first act was passed in 1950. The specifics of the act are quite well defined by some of the testimony in the House series of meetings that they are holding. Richard Donnelly, who is the Assistant Deputy Under Secretary of Defense for Manufacturing and Industrial Programs, has come out with some specifics covered in my written testimony that I submitted. But it's interesting to note that during the past year we had to use title I priorities and allocations because we lost half of our ammonium perchlorate in one explosion in Nevada, and if we didn't, this act to provide control, we might have lost that capability.

Then, in title III, Expansion of Productive Capacity and Supply, Senator Dixon has introduced the concept of a revolving fund to support emerging title III projects looking at new industries, emerging technologies, such as HDTV, electric propulsion for ships or whatever else we might have: Senator Heinz brought up the issues of foreign ownership also covered in title III. We have already had cases in which foreign companies have bought parts of our defense base and after the foreign owners took ownership they said, "Oh, we will not go into production in that program. You will have to find another supplier." It is very costly to us.

So there are certain specifics in the act as it exists today that probably need to be carefully looked at.

I think it's obvious to all of us that there's an interdisciplinary, interagency, interactive array of activities going on in the environment today that impinge directly on the technological and manufacturing leadership in the United States. The world is a different place than when the first act was put together and we need to carefully review these interdisciplinary issues and I'd like to touch on five very briefly.

TECHNOLOGICAL LEADERSHIP

Secretary Carlucci has already indicated some areas in which we are ahead. How do we maintain that leadership? What is the Government's role? In emerging technologies we are asking what is the Government's role, say, for HDTV? There's been a lot of focus on that. It's not clear today what that role should be. Certainly subsidization and picking winners and losers is not the role, Senator Gramm, so we agree on that to start with. But there is a role for the Government to play.

In some areas we've lost our competitiveness and we have worked hard in the Department of Defense to put programs together like SEMATECH and then the National Center for Manufacturing Science, which happens to be in Ann Arbor. There is a role there because the Defense Department is not the big gorilla on the block for technology today. It's a participant in this rapidly evolving technological base.

I think all of the three witnesses here certainly feel that you can't have a strong technological base unless you have with it a strong manufacturing base to provide the skills, technologies and the concurrency that Secretary Carlucci has already addressed.

Certainly, it's important that we bring up the subject of economics since we're at the Senate Banking Committee. But I think it's important that we look and say 10 years ago 7 of the top 25 banks in the world were U.S.-based. In 1988, only one of them was and it was way down on the list. That can have a serious impact on not only technology but certainly in manufacturing where other people dictate where plants will be built and who will build them.

There are many other economic issues such as taxes and duties and foreign subsidies and foreign investments that have to be carefully reviewed.

I cover a broad spectrum of issues under what I call social issues. It deals with everything from the discrepancies we find in education—and we reviewed that quite thoroughly in "Bolstering Defense Industrial Competitiveness"—to also the issue that Secretary Carlucci raised and as did Admiral Inman—total quality management. That's an evolution as to how do we manage our companies. It covers technology. It covers manufacturing. But it also covers engineering and the way we treat the management perspectives that are so key that perhaps the Japanese have excelled in and showed us over the past several years.

POLITICAL ISSUES

Yes, there are political issues. We have local, State, Federal and international political issues. In many cases, they are contradictory. We have some local agencies trying to almost bribe companies to come to invest in the United States and we have in many cases the Federal Government saying, "No, we don't want that investment."

The United States has not developed a mechanism to establish any sort of consensus in this area and our adversaries—military and industrial—use this apparent disarray to their advantage. And our allies are often bewildered by the apparent conflicts that this diversity presents to them. So it's a major issue for us.

If we look at the Defense Production Act, we can reauthorize the bill in the narrow context of the previous bill or we can step out now to boldly address the role of Government, industry, labor, and academia in placing the United States in a leadership role worldwide in technology and manufacturing.

A strong national defense really demands that we look broadly at the issues today. There are thousands of answers we could give you. They are well-reasoned but unique, narrowly scoped solutions to the problems. And that's not the real world we live in.

What is needed is a platform such as this committee is providing us in which the issues can be addressed and discussed and the appropriate compromises defined and implemented. I think it's extremely important that we have implementation as a part of our review.

Some level of a control is necessary, at least to avoid duplication and conflict. Since U.S. industry is committed to the use of foreign parts and technology, the Department of Defense cannot arbitrarily ban the use of any foreign material in any product that we have, because, if we did, we would stop production tomorrow.

The issues are complex, will not be resolved with simple dictates from top down. The committee and the chairman are to be complimented for undertaking the variety of issues before us today with such a broad scope at this time.

Thank you, sir.

[The complete prepared statement of Dr. Robert B. Costello follows:]

TESTIMONY

by

ROBERT B. COSTELLO
Hudson Institute

FORMER UNDER SECRETARY FOR DEFENSE (ACQUISITION)

before the

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

July 11, 1989

Mr. Chairman and Members of the Committee:

It is a distinct pleasure for me to testify before this committee today since I have been concerned with the Defense Production base for several years. The first major effort that I undertook as Assistant Secretary of Defense for Production and Logistics in 1987 resulted in a report to the Secretary of Defense that has had unusually wide distribution. The report, "Bolstering Defense Industrial Competitiveness," represents the first effort within the Department of Defense to evaluate the government's options to insure the necessary production base for a wide variety of defense needs.

The first Defense Production Act in 1953 addressed a production base that has changed drastically since. I am sure that Members in writing the original bill reflected upon the tremendous outpouring of war machines that the United States achieved during World War II. Members may even have had in mind the production of about 4500 airplanes in November of 1944 for use as a goal against which to measure preparedness. It might be noted that we do not make 4500 aircraft a year today--in fact, we hardly make 450! This is not our goal today, but today's goal is just as challenging.

As we look at the act, there are a number of specifics that will be addressed by others.

One of the better reviews of the issues is the testimony of R. E. Donnelly, Assistant Deputy Under Secretary for Manufacturing and Industrial Programs, before the House Banking, Finance and Urban Affairs Subcommittee on Economic Stabilization. Here, specific issues under review are carefully analyzed to assure continuance of the basic concepts within the act as it is today.

Perhaps it would be appropriate at this time to enact permanent legislation rather than the reauthorization every two or three years as in the past. There are authorities vital to the Department of Defense within the the act that would benefit from permanent legislation.

The core provision of the act is a statement of national policy making explicit the key relationship of the national economy and national security. I am sure that this relationship is viewed as even more critical today than when it was introduced in the 1980 reauthorization. This interaction does not preclude pursuit of the advantages to be gained from international cooperation, but the international influence today takes on even greater significance in areas of finance, technology, and, certainly, manufacturing.

Title I--Priorities and Allocations--is key to the DoD to establish with the Presdient critical priorities. Title I was used recently to control the use and export of ammonium perchlorate when supplies became critical due to the explosion at a Nevada plant, which resulted in the loss of one half of the nation's capacity.

Title III-Expansion of Productive Capacity and Supply--becomes even more important as we look at the role of government in bolstering the industrial base in specific areas. I would like to compliment Sen. Dixon on his recommendations for establishing a perpetual revolving fund to finance emerging Title III projects.

Other key provisions are contained in Title VII--General Provisions. The improvement of industry-government exchanges is extremely important to the overall intent of the Defense Production Act. An up-to-date database of industrial data--Socrates and DINET--on which to base decisions is imperative. And Section 721 authorizes the blocking of mergers, acquisitions or takeovers of American firms by foreign persons if they threaten national security. This section takes on an importance today few people recognized in earlier versions of the bill. There have been instances in which foreign buyouts of U.S. defense contractors and the new directions of their management have resulted in a key supplier no longer being allowed to participate in DoD business.

We should take care at this time, however, to look at the broader issues of manufacturing and technological leadership. At Hudson Institute we have set guidelines for an agenda for technological and manufacturing leadership in the United States. The world is a different arena today and the Defense Production Act needs to carefully address the interdisciplinary issues of:

1. Technological leadership. The United States must have a specific strategy varying by technology aimed at maintaining our lead where it does exist, regaining our lead in key areas--such as certain semiconductors, bearings, and machine tools--where it has slipped, and establishing our leadership in emerging technologies.

This last area was addressed by Congress last year, and the DoD submitted in February its first report on 22 key technologies. We must pursue the issues raised in the report. What is being done in each technology? What is the specific strategy for each? What are the roles of the other federal agencies such as the Department of Commerce in helping to ensure U.S. leadership? Continued investment in technology alone is not sufficient to maintain leadership. The interdependence of various segments of technology and manufacturing must be evaluated, and those evaluations must influence the funding and direction of future R&D.

The Department of Defense has several programs dealing with the industrial base and key technologies. Critical will be the DoD's support for merging the manufacturing/technology information that is well established in separate databases. Once merged, the data can be used to evaluate present directions of R&D, to plan aggressive reviews, to eliminate duplicate efforts, and to channel funds into those areas suffering neglect. With ongoing support, DIA's Socrates program and OSD's DINET would form a single, continuously updated database so urgently needed for strategic manufacturing planning and would provide critical information for budgeting not available today.

2. Manufacturing. Can a nation maintain a significant technological lead without a substantial manufacturing base? How does one maintain the concept of concurrent engineering, in which product and process design and engineering proceed in parallel? Concurrent engineering is key to worldwide competitiveness, and it demands manufacturing leadership rather than more narrowly based funding of technology alone. How can the leadership that the United States has enjoyed for the last 40 years be sustained if there is not an adequate industrial base through which the critical R&D is supported?

I have described this in the past as a situation in which Defense needs the technological leadership likened to the top 20 stories of an 100-story building. It must rely on the commercial segment of the industrial base to provide the base technology--the first 80 stories--on which Defense depends and for which Defense has significant responsibility. Today, there is one industrial base, integrated and interdependent. It must be strong in the key technologies, and DoD's resources must be used to strengthen the areas identified as deficient.

3. Economics. It is certainly appropriate to discuss economics at a Senate Banking Committee hearing. Let's establish the basics for our concerns. In 1978 seven out of the world's top 25 banks were U.S.-based. In 1988 only one of them was U.S.-based, and that one is, in fact, far down on the list. There should be grave concern about the international flow of money and about the ability of those who control the money resources to exert significant influence as to who is funded for critical research and development and where the manufacturing will take place.

There are other economic issues as well that fall outside of the normal purview of the DoD but are strategically important nonetheless. Taxes, industrial incentives, duties, foreign investment and ownership, and procurement subsidies here and abroad are all real issues that must today be brought before this Committee as it considers changes in the Defense Production Act.

4. Social issues. There is a broad spectrum of interests with significant impact on defense preparedness. In "Bolstering Defense Industrial Competitiveness," one of the key social issues focused on the deficiences in training and education. The report described the serious deficiencies in all levels of academia and industrial training (elementary through the graduate levels) in the United States.

When social issues are reviewed, pay, benefits, retirement and Social Security are usually studied and compared nation by nation.

Another issue, though, that needs at least as much attention deals with the way the United States manages the industrial base--both defense and commercial. Yes, where are U.S. companies with respect to the broad implications of TQM (Total Quality Management)? Do they have in place a concept of employee participation, continuous process improvement, demonstrated world-class leadership in cost, quality and technology? And do they have a critical analysis of their industry worldwide against which they are continuously monitoring themselves? Have the unions participated in defining their new roles and their interaction with their constituents and management?

5. Politics. Yes, that is why we are here today. There are local, state, federal and international political issues just as real as the design of new state-of-the-art microprocessor chips that impact our industrial base leadership. The United States has not developed a mechanism to establish any sort of consensus in this arena. Our adversaries--military and industrial--use this apparent disarray to their advantage. Our allies are often bewildered by the apparent conflicts this diversity presents. Shouldn't there be a mechanism at the highest level in the administration to put the United States on an even footing with the rest of the world in this area?

These are the interdisciplinary issues that are before us today. We can reauthorize the bill in the narrow context of the previous bill or can step out now to boldly address the role of government, industry, labor and academia in placing the United States in a leadership role worldwide in technology and manufacturing. A strong national defense demands that we do.

Today, there are a thousand well reasoned but unique, narrowly scoped solutions to the problems. They range from "don't do anything, the free market will prevail" to "control everything, no one knows better than we do as to what is needed." What is needed is a platform; you have provided the country with this one (the Senate Banking Committee) in which the issues can be addressed and discussed, and the appropriate compromises defined and implemented.

Some level of control is necessary. DoD can not afford to finance R&D stages in programs only to be forced to start with a new supplier when the new owner--sometimes foreign--says he will not carry on with the program into production. Since U.S. industry is committed to the use of foreign parts and technology, the DoD can not arbitrarily ban the use of any foreign supplied material--all production would stop. As I have indicated, the issues are different from those 35 years ago. They are complex and will not be resolved with simple dictates. The committee and the chairman are to be complimented for undertaking this issue with such a broad scope at this time.

The **Chairman**. Thank you very much.

I think you've already seen this morning by members that you've heard from on this side of the table—the State if Illinois represented, the State of Pennsylvania, Michigan, my home State, the State of Texas—and I think the committee as now constituted collects broad national sense of a number of these issues that will let us work our way through this with experts like yourselves who we want to continue to work with beyond today. We asked you to come first because we thought what you would have to say would be the most important testimony that we would hear and we wanted to set the stage with that.

UPGRADE THE DPA

But it is my intention, and it will be the intention of the committee, as difficult and as complex as these issues are, to work through them very carefully to try to upgrade this Defense Production Act in the way that we need to and strike this balance, because we're talking about a balance. We are not talking about a philosophic purity of one extreme or another. We're talking about how do we come up with a rational, pragmatic, sort of forward-looking strategy that fits the world that is evolving each day.

There are some who say don't worry, be happy, that somehow it will all work out. I don't get that sense from your fellows today. I sense from each of you a real sense of urgency. Am I reading you right?

Mr. **Carlucci**. Yes, sir.

Mr. **Inman**. Yes.

Dr. **Costello**. Yes.

The **Chairman**. I also sense that while I don't know that there's anybody that is not a believer in a strong private sector economy—I certainly am and have seen the great benefits it's produced for us. By the same token, my observations in talking with a very broad cross-section of American industry all the time in my State and across the country is that the kinds of challenges that you've laid out here are ones that the private sector by itself cannot necessarily solve. Is that also the case?

Mr. **Carlucci**. I think Admiral Inman put it correctly when he said Government sets the environment within which the private sector works. So Government has to set the overall tone.

The **Chairman**. I know this can start to spin off into a philosophic debate. I have no interest in getting into a philosophic debate, although we can do that, but it seems to me that Government has to be active and constructive in playing its part, whether it relates to availability of capital at reasonable rates, which was mentioned, or whether it's talking about an educated work force.

I am very distressed when I see these comparative high school dropout rates of 24 percent or so in the United States and 2 percent in Japan. I say to myself, how over a period of time, can we as a society produce at the level of personal output to produce the national income that the country needs if we're having fully a quarter of our people that are coming into the work force without even the basic skills that one acquires through the high school graduation level. That seems to me to be unworkable and it's one thing if you make a comparison with the Soviets and their difficulties—and certainly they have them and they are trying to adjust—but I'm much more concerned frankly about Japan and the Japan models—Korea and others—in terms of the performance that they are toting up.

BACKWARD SLIDE OF FINANCIAL INSTITUTIONS

When you went through your list of bank ratings globally and the backward slide of American financial institutions, of course, the Japanese institutions are by and large the ones who have taken our place.

Well, I take it then you are also saying in various ways that we genuinely need a national strategy to try to work our way through an adjustment process here that will get us up to the level of aggregate performance that we really need to see. Is that also a conclusion that each of you have reached?

Mr. INMAN. Mr. Chairman, we may each have a slightly different formulation.

I think what we really need as a country is to look at the whole range of problems and say what does the Government need to do, what does the private sector need to do, what do the academic institutions need to do.

The CHAIRMAN. But that's a team concept. I don't hear you saying that each goes off and does it in a vacuum or that you do it willy-nilly.

Mr. INMAN. They can't.

The CHAIRMAN. It sounds to me like what you're saying is a very fundamental proposition, and that is that the scale of the task now requires what you might call a Team America approach and different sectors will have different responsibilities, but I take from what you're saying that we need some kind of a coordinated strategy, not just an ad hoc random strategy. Is that correct or not? Am I hearing that or not hearing that?

Dr. COSTELLO. Mr. Chairman, I think that's quite appropriate and it has to be interdisciplinary. It can't be a stovepipe because we do have in our stovepipe analysis some highly prejudiced people who say this is the only way to handle my industry. I've sat in a number of meetings in which the industry has been divided into halves, one that wanted to manufacture in the United States and the other were importers of foreign goods. We've got to get those people together. We can't be diverse and divisive as we approach these issues.

The Government has a role, not to direct and manage, but to act as a catalyst to get these things started.

The CHAIRMAN. Who else is likely to be the convener? I'll give you an example in a minute but, Mr. Carlucci, you wanted to make a comment?

HOSTILE RELATIONSHIPS

Mr. CARLUCCI. Well, I think one of the things Government can do is in many instances to get out of the way, to stop doing the harmful things that it is doing to the defense industrial base by some of the activities that I pointed out in my earlier statement—unstable funding of the defense budget, a hostile relationship between contractors and Government.

The **Chairman**. I accept that. I think there are some things Government is doing that it probably ought to stop doing. There are some things that it's doing that it ought to do differently. There are probably some things we are not doing that we should be doing. There's probably an array.

But from a process point of view, I mean, once you're at that point, how do you even convene a process or put the right people in a room around the table or in separate rooms—what is the means by which as a nation we collect ourselves around this set of issues to work them through? What is the nature of the problem-solving process here that we ought to think of in the way of a structure? Because otherwise, if we just say, look, we really need to do all of this but we're not quite clear as to how to do it, then it seems to me we just kind of drift on down the stream.

Mr. **Inman**. Mr. Chairman, the reason for agreeing to come to the hearing today was a conviction that leadership from the Federal Government is critical to focus attention on the problems and to raise the overall national sense of urgency to deal with them.

It's not going to happen unless there is a focus by this level on the problems. When I was an undergraduate back in the late 1940's, one of my learned professors held forth that we had had 20 years between World War I and World War II. In his judgment, we would be lucky if we got 10 years between World War II and World War III. We've been lucky to get more than 40 years, but we've got a very different world out there where our primary political and military allies are our major economic competitors. And unless we begin to deal with our own ability to compete successfully in that arena, we're going to see our standard of living continue to erode, as it has already eroded in these last half-dozen years.

The **Chairman**. Well, if I may, Mr. Costello, and then my time is expiring here.

Dr. **Costello**. My compliments to the committee, this committee can act as that focal point. We at the Hudson Institute also feel very strongly with regard to those same issues. How do we get these people, a cross-section of people, together to discuss openly what the issues really are and to come up with those compromises?

The **Chairman**. How do you do it without scaring some people to death? My colleague from Texas is obviously very concerned that "Big Brother" is lurking right over the horizon and central planning and there will be somebody deciding how many brown pair of shoes and how many black pair of shoes—nobody in their right mind wants that and that's not going to happen so I think that's an exaggerated fear. But in dealing with that concern that some have, we are still left with the question, how do we devise in this new state of affairs, this new global situation that we're in, this relative change in national position—how do we develop a mechanism as a nation just to talk to ourselves and to start to work these issues? How do we do it without running into conflict with our essential private sector orientation? How do we get this blend? How do we form a Team America sort of work process?

Dr. **Costello**. We did that when we put together the defense report to the Secretary, "Bolstering Defense Industrial Competitiveness." I think I probably could have written the report the day I walked into the office. We took 1 year to aggressively look at all aspects, all the different points of view, and put together a report that was reasonably accepted by all, a consensus, as to where we can go and what the role of the Defense Department had to be in that area.

I think that we've got to establish some mechanism for putting that broad consensus development together because otherwise we have those people that are poles apart.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

LACK OF SURGE CAPABILITY

There are, I gather, a lot of problems that have been discovered over the last several years about our defense base and its ability to do what needs to be done. For example, surge capability is somewhere between minimal to nonexistent. We can't even surge one system; and obviously, if you're going to have a surge you need to surge a series of interrelated systems, not just a production line.

That suggests that we need a broader team approach to looking at this issue, as Senator Riegle describes. My question is, do you see any practical value in establishing an advisory committee to the President which would concentrate on that and other current problems affecting our ability to mobilize our defense industrial base, both in terms of various economic policies that would be important, as well as the ability to meet mobilization requirements?

Let me start with Frank Carlucci.

Mr. CARLUCCI. Senator Heinz, I think you've identified the problem. Yes, we do lack surge capability. On the other hand, I don't think you can look at that in isolation. It has to be looked at in the context of the defense budget. It has to be looked at in the context of multi-procurement. All kinds of other issues are interrelated.

Senator HEINZ. May I interrupt you, Frank, to ask you this. You say it needs to be looked at in the context of the defense budget, but isn't that really too narrow a way of looking at it? Here's a defense budget which is $300 billion, only a portion of which, some $60 billion, is procurement oriented, in a $3 or $4 trillion economy. It seems to me it doesn't make any difference whether the defense procurement budget is 20 percent larger or 200 percent larger, no matter how many years it stretches out.

What you are making use of when you make a decision to make defense procurements is not just that little bit of the economy that is committed to the defense procurement system, but all the rest of the economy. It seems to me if you look at it narrowly, you're never going to ever come to grips with the big problem, which is why I asked the question I did, which is, don't we need some broader way of looking at this that's not just defense but goes more broadly to our national security economic base, not just, if you will, the defense subpart of that?

Mr. CARLUCCI. Well, that's a fair point. If you're going to have to have a surge capability, say, in tanks, you've got to have industry surging all the way down to the subcontractor level.

Senator HEINZ. You have to have a specialty steel industry.

Mr. **Carlucci**. On the other hand, it does us no good to surge in tanks if we run out of missiles and we're almost totally dependent on foreign components for the Sparrow, the Sidewinder, Maverick missiles which are the first things to go in any kind of conventional war.

So my point is, it's a mistake to look at one problem in isolation.

The second point I would make is that Admiral Inman's investors, if he says, well, I'm going to develop some excess capacity in the electronics industry, the investors are going to say, well, where's our return going to come from on that? We're giving you the resources. We want to put them where we get our best marginal return. So some kind of broad incentives have to be provided.

OPINIONS OF AN ADVISORY COMMITTEE

I frankly don't think an advisory committee can solve this kind of problem because it would focus on one narrow aspect of what is a far broader problem.

Senator **Heinz**. Let me ask Bobby Inman what his view would be. Let me just say, Frank, in reaction, the idea of the advisory committee is to give attention to national policies that will provide the environment, whether it involves incentives or something else, to have the base that we need. That is the idea, just so we're clear on that.

Mr. **Inman**. My reaction: usually you shudder about yet another series of advisory committees, but this is one I would support—particularly if membership was carefully constructed—because what we ultimately need is to be able to persuade the President and his key advisers. When you're in an environment of declining budgets, and I suspect we're going to be in that mode for quite a long while, you need people who aren't drawn into that daily fight to protect their own resources to be able to look out more broadly.

I have a view from these 7 years, Senator Heinz, that we should lay down as a fundamental requirement a viable commercial marketplace as what we're looking for in our overall industrial capabilities. And I think it should be extraordinarily rare that we support a totally defense-oriented industry. I understand why shipyards and a few other things fit in that category, but I think they should be exceptions, not the rule.

That led me to go see Bob Costello on behalf of a new idea called SEMATECH where I have no investment, and no interest in any of the companies that were participating, but I was persuaded that Government needed to play a role in funding what would ultimately provide the equipment that would ensure the commercial viability of these companies.

So I think an advisory committee must be broader than a single department and look at that need for a broad commercial base.

Senator **Heinz**. I think that's an absolutely critical point—the viable commercial marketplace—and it leads directly to the other question I wanted to get into, which involved high definition television. We all know that high definition television confers to the people that make it and the components of it enormous advantages of scale in semiconductors, integrated circuits, and a variety of other key critical technologies both for the defense and for the future.

JAPANESE CREATING A COMMERCIAL MARKETPLACE

Now the Japanese are in the process of doing something fascinating. They are creating a commercial marketplace by governmental force majeue. The Ministry of Posts and Telegraphs has sent a directive to the 13 largest municipalities in Japan that says, "Please come back to us with your plans to purchase and promote and market and create a market by having, if you will, a HDTV set in every hotel room in every public place and so on and so forth"—a market for HDTV.

Now my view is that that market is worth more money than we could ever shovel out to our electronics industry because a market confers a variety of other different kinds of advantages. It's forever. It encourages competition.

My question is this. If we believe that HDTV confers the major technological economies of scale that a lot of people say it does and if we believe that another country has a very effective what you might call a developmental capitalist strategy where the government is an active player in making a market, what should we do about it?

Dr. COSTELLO. Senator Heinz, I have spent a lot of time on HDTV and I'm quite concerned as you are. In the DOD we have, most often, put money into the technology only. We don't even look at the supporting technology in the supplying industries in the electronics industry as well as others.

The Defense Department may be that critical market mass to get things started where we can be commercially competitive. It turns out on HDTV there are a lot of applications in the Defense Department, but unless there's a broad commercial base to drive the costs down, the Defense Department may not be able to afford it. So we've got to get broader scope, broader perspective in this area.

As far as your committee is concerned, the Vice President is chairman of the task force on competitiveness. I had suggested that maybe he might want to take a look at that committee as the unique high-level committee structure to look at the issues across the agencies because it is not a single agency issue. That might be a mechanism to get something like that started.

Senator HEINZ. But my question is, let's assume you're the President. What should be the U.S. response to what is a very real and present threat to the viability of everything that Bobby Inman is working for and a lot of other things in the future?

Dr. COSTELLO. We have to ensure some part of that market is ours so that we can optimize and take advantage of the technologies that we have.

Senator HEINZ. How do we do that without being protectionist? Is that the only way to do it?

Dr. COSTELLO. I think that you cannot be protectionist because you may subsidize industries that are reactionary instead of leaders. So you've got to have a different approach than just building walls around the country. That does not enhance our technology.

Senator HEINZ. What is that approach?

Dr. Costello. I'm going to put my sales pitch in. I think we need to get some key people together from both extremes to answer Senator Gramm's concerns, say, "Hey, you guys in Washington don't know everything and there are a lot of other people that have some resources they need to bring to bear." We do have two segments. One, I'm importing from Japan, leave me alone; the other manufacturing in the United States, but constrained by a variety of Government, industry and company rules and regulations that must be reevaluated in light of today's international industrial competitiveness.

Senator **Heinz.** Well, my time has expired.

Mr. **Carlucci.** I'd just make a quick comment. I think in areas where Japan is ahead, we need to look at ways of cooperating with Japan and we cannot adopt a mentality that simply says we have our technology and we're going to protect it. We have to move aggressively to get technology inflow from our allies, particularly Japan.

I disagree with you, Senator Heinz, on the FSX. I think the merit——

Senator **Heinz.** It was mutual.

Mr. **Carlucci.** I know that. But I think the importance of it was that it established a technology inflow, at least a precedent for technology flow from Japan to the United States. I mentioned earlier that in the 22 critical technologies that the Pentagon has identified, Japan is ahead in some five. We need to work on cooperative ventures to get technology flowing from Japan to the United States under the 1983 Nakesone agreement.

Mr. **Inman.** Mr. Chairman, if you will tolerate us being over time, I'm always reluctant to be in disagreement with my friend, Frank Carlucci, but in this case I think the marketplace is so huge and the impact commercially is so large that we need to try to foster an aggressive U.S. commercial activity.

Now how do you foster that? I think we've seen a good beginning with DARDA's funding to push forward the frontiers of technology. I happen to like the FCC's action to buy us some time in what's going to be the accepted standard.

What I don't yet see is an eagerness on industry's side to move, and I wonder if that is in fact an antitrust issue, where we may need to encourage several companies to get together to look at producing and marketing—not the government to do it, but to say we consider it sufficiently important to have a United States vital industry that we would look at some relaxation of antitrust.

The **Chairman.** Well, I would hope before we go to our next colleague that if that's what needs to be done that we would consider doing it. It's very frustrating to watch Japan, for example, as a case in point, be able to move in different directions, to make consortium attempts to do things and to move the equation very effectively to their advantage and often to our disadvantage, and yet we're tied in knots. We just can't seem to be able to sort of pull ourselves together sufficiently in a comparative sense.

Senator **Heinz.** Mr. Chairman, could I make an editorial comment in response to what Bobby Inman said?

The **Chairman.** Please.

Senator **Heinz**. I think he's right as far as he goes, but my answer to the question of where's our industry, why isn't it out there pushing, would be, if you saw a highly organized competitor that had benefited from somewhere between $800 million and $1 billion worth of Government support for R&D on high definition television, and you saw that they had a strategy for lowering the unit cost from $40,000 or $50,000 down to something affordable within the foreseeable future, and you don't; why would you want to invest one dollar in a market where your foreign competitor not only had a 10-year lead on you but also has an economy of scale that you can't see matching and therefore a price advantage that means you are never going to be competitive. Why would you want to put one dollar into that business unless it was somebody else's dollar? Therefore, we have the American Electronics Institute and companies saying, "Give us a billion dollars." To which my answer is, I don't think that's the answer either.

I thank you very much.

The **Chairman**. I'm going to move out of order at the courtesy of Senator Sanford and call on Phil Gramm next here.

Senator **Gramm**. Mr. Chairman, let me thank you.

Let me make just a couple of comments, and then I've got some questions.

SHOULD GOVERNMENT BE INVOLVED?

It never ceases to amaze me, that we act as if, when Government does not make a decision, then no decision is made. The truth is that the genius of our system is that we have millions of decisions made every day, every hour of the day, by people who have the information and who have incentives that Government does not have. If by a team concept you're saying that Government has a role in promoting a dynamic, growing productive society, I agree.

The question is not, should there be a team concept, should Government be involved; the question is, how should it be involved?

Now if you're saying Government is doing a poor job in providing public education, I absolutely agree. It's outrageous what we have done in education, often promoting by Federal policies other things than teaching Johnnie and Sue how to read, write and reason. In fact, the primary thrust of Federal policy has been completely in the opposite direction.

If you're saying Government has a role in promoting a sound economy by balancing the budget, by lowering interest rates, by changing laws to make American industry more competitive, recognizing there's only one market in the world and that's the world economy, and that a system of regulation that might have made sense in a relatively closed economy where foreign trade was unimportant now no longer works, I absolutely agree with that.

But I guess the point I want to make is that if you think that's what we're talking about in this legislation, you are greatly misled here. We're not talking about all those things. That's not what Team America means in the context proposed. Team America means protecting the machine tool industry. That's what Team America means here. That's what a major proposal is that we're going to be debating.

MACHINE TOOL INDUSTRY AND FOREIGN COMPETITION

I'd like to begin by asking each of you, do you believe that it should be the policy of the Congress and the country to protect the machine tool industry from foreign competition? Let me start with you, Frank.

Mr. **Carlucci**. First, I haven't looked at the machine tool industry close enough to know what its current status is. If it was in dire straits and we weren't going to have a machine tool industry, then I would indeed put up protection with a sunset clause of four or five years to see what they did about making themselves competitive in that timeframe. Would I agree to a time immemorial protection? The answer is no.

Dr. **Costello**. I think we took some action in the Defense Department that said if you, the machine tool industry, can get your act together and do something to overcome the deficiencies that have grown over a period of time because of your inattention, we will play a role. We were instrumental in putting together the National Center for Manufacturing Science. It's a group of 80 companies representing the users, the machine tool manufacturers and the suppliers. The Government's role is a very minor role. A sunset clause, 3 years of $5 million a year, and this program in Michigan is off and running and it is doing very, very well. But they had to commit the bulk of the money. They had to take the bit in their hand. They probably wouldn't have done it unless the Government had been a catalyst. So I want to put their feet to the fire. Protectionism is the wrong way to go because we end up with obsolete technology and high costs.

Senator **Gramm**. It would be great if behind this wooden table we had gods sitting with great insight into what were going to be the economic winners and losers of the future. The plain truth is, we don't have the foggiest notion. As far as I'm aware, there is not a person in the U.S. Senate that knows anything significant in the way of understanding the technology of high definition television. It is a buzz word that we have all heard from all these special interest groups that want the Federal Government to give them money and fund their research.

My own view is that we ought to be funding research. I support primary research. I would like to see it centered in the universities. I would like to see it in consortiums where the objective is to develop new technology. I am adamantly opposed to development and commercialization. I look at what we did in synfuels and see an absolute disaster.

The problem is, when you start making choices, there are not going to be choices made by some group of scientists, even if they were objective. Their problem is lack of knowledge about what the future is going to be. I have a great concern at two levels, so let me pose it in a question.

One is, even if you could get the best scientific minds in America together and they could make a recommendation, would it be right? I have no confidence in that.

Second, what is Congress going to do with the recommendation once they get it? Do we really believe that we allocate resources in the American Government based on economic efficiency?

I'd like to end by just asking you, do you share these concerns?

Mr. **Carlucci**. I certainly share those concerns. If you start protecting one industry, there is no end of candidates and there's no end to the process here on the hill that would protect those candidates.

Mr. **Inman**. My own concern at this point, Senator Gramm, is that the deterioration of much of our industry is sufficiently worse than the comments today would lead one to conclude, so I don't want to rule out that there would be occasions when I would support protection for a limited, set period of time. I would not want that to be a timeframe in which the protected industry could take their money and go invest somewhere else. There would be a public compact that they're going to take the earnings to make themselves competitive in the international marketplace.

Are we able to project at this point which industries are going to win in which markets? Not in explicit terms, but we do know in broad terms where technology is going. We know which are the leading edge technologies. We know where there's a whole new frontier opening up.

We let consumer electronics get away from us in this country for a variety of reasons. I don't think we ought to give up on a whole new generation when you also think about the display technology, which may be extraordinarily important to defense down the way, that you'd rather not spend all those development costs on.

So I'm not ready to come down hard and fast on HDTV.

Dr. **Costello**. I think there is a question about wisdom here in Washington because it was about a 100 years ago the head of the Patent Office suggested that everything had been invented and we should close it down. So this isn't the place for all wisdom, I agree with you.

But I had an opportunity to work with the steel industry when I was with General Motors. I bought more steel than anybody else in the world. The steel industry in the United States was in terrible shape. It's not in bad shape today. They made some major changes.

What we did, we went to the industry—a sunset clause again—and we said——

Senator **Gramm**. Let me just stop you there and I'll just end on this. The 5 years is up. Should we extend the protection of steel or not?

Dr. **Costello**. I gave them 5 years and I said, "Here are the marks you must meet as you get more productive and more efficient and higher quality. If you don't meet them, I'll have to go buy someplace else.

Senator **Gramm**. OK. The 5 years is up. They had the 5 years. Do we give them 5 more years like they ask or not?

Dr. **Costello**. I asked the head of the American Iron and Steel Association last night, I said, "after voluntary restraints, what's next, because you cannot continue that as a mode of operation?" We have to look at what's next. They have not even defined it or even studied it because they think they're going to get from your and others another 5 years.

Senator **Gramm**. They aren't going to get it from my help, but they probably are going to get it. That's my point. We will be protecting steel for the rest of the survival of the republic unless we're very, very careful. The problem is, once you get into these things you can't get out of them because they then build a political base, and it's as if God has decreed that steel will always be protected because, after all, how could America survive without it?

Dr. COSTELLO. I think, Senator, you and I are on the same side. I said after VRA, what next? We have to have a different answer.

Mr. INMAN. But, Senator Gramm, if you ever have a chance to go down in our State and look at Chapparal, I urge you to do it. It is competitive.

The CHAIRMAN. Senator Sanford.

Senator SANFORD. Thank you very much, and let me express my appreciation to members of the panel for taking their time and energy to come and advise us.

I have an opening statement that I will put in the record, Mr. Chairman.

The CHAIRMAN. We will make that part of the record.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you, Mr. Chairman, and I would like to welcome our distinguished former Secretary of Defense, Frank Carlucci, the former Deputy Director of the C.I.A., Admiral Bobby Inman, and Dr. Robert Costello, the former Under Secretary of Defense.

Today, we meet to hear the testimony of this panel on the Defense Production Act Amendments of 1989, and on competitiveness, and the health of our defense industrial base. The Defense Production Act, first enacted in 1950, provides for the development of preparedness programs, and insures the productivity capacity of the defense industries to enable full mobilization in the event our national security is threathened by foreign sources. One of the issues before us today is the extension of this act which is due to expire September 30 of this year. This year the administration has requested Congress to extend the authority of the act permanently, as in its view, such an extension would allow for more efficient planning, and would be more cost effective for the defense industries.

The amendments as offered by the administration reflect the changes that have occurred in the international arena and in the U.S. defense industrial base. We have witnessed the loss of U.S. superiority in the electronics and semiconductor industries which are the foundation for many of our defense industries. The amendments seek to bolster the commercial industries which supply relevant research and resources to the defense industries. The intent of the amendments is to insure that defense readiness is maintained.

I support strongly the intent of the Defense Production Act for I believe it to be imperative that we maintain our readiness and insure our defense industries are able to reach their surge capacities. I am grateful for the exchange that will take place today between the three distinguished witnesses and the committee. I am of the understanding that Senator Dixon may introduce today his version of the Defense Production Act Amendments of 1989. The legislation offered by Senator Dixon addresses many of the concerns I had with the administration's proposal, including the request for permanent extension of the DPA and the various changes to the title III program. I would be interested in receiving feedback from this panel comparing the Dixon bill and the administration proposal.

Thank you for holding this hearing, Mr. Chairman. I look forward to the testimony of our witnesses on this important subject.

PURPOSE OF THE DPA

I believe the basic question is, should we extend the authority of the Defense Production Act. I don't know whether that question has been asked or whether or not each of you has expressed an opinion on it.

The Defense Production Act was enacted as a wartime measure, I suppose to keep us competitive at the time. Now that we are not at war, should it be the purpose of the Defense Production Act to keep us strong in our defense capacity? Is it the purpose to keep us competitive worldwide? Or does it have a purpose? Should we reauthorize the act or is there a better way to address the competitiveness problem?

Mr. **CARLUCCI**. Senator Sanford, I do not think the purpose of the Defense Production Act is to enhance U.S. competitiveness in the broad sense.

I think its purpose is to deal with critical defense exigencies as they arise. Now that's a very fine line and the purpose of the debate up here is to decide where that line is. But I think it has to be used very sparingly and I would become nervous if it were to evolve into a broad instrument of control of the economy or allocation of resources. It is designed to deal with the kind of emergency that Dr. Costello mentioned a while back. I don't know if you were here. It is not designed to stimulate industry in general.

Senator **SANFORD**. Admiral?

Mr. **INMAN**. Senator Sanford, from my too many years in government, I view these hearings sort of two-fold. One is to deal with specific legislation and I subscribe exactly to what Secretary Carlucci has said.

But I think they also do serve as one of those rare instances to try to generate a broader public understanding of a larger problem.

So I would encourage, as the committee addresses the Defense Production Act, that they not miss the opportunity to bring significant focus on a whole range of other industrial competitiveness problems that simply aren't being addressed with the urgency that I believe they should be.

Senator **SANFORD**. I'll come back to that in a minute.

Dr. **COSTELLO**. I think that I'm on record and I certainly support my former boss that we don't want to have this as a means of opening up a total control, a centralized control. There is one industrial base from which the Defense Department draws its needed requirements.

We had a study done last year. Two hundred and fifteen separate industries are significant suppliers to the Defense Department. We can't put down a single recipe for resolving all those problems.

In some, the Defense Department is the dominant user, the customer. That's different than perhaps in the pharmaceutical industry where we're just a small fraction of the business and surge is not even a problem for us perhaps in that case.

So I think that, yes, we have a role to play, but it's not a role to use this act to establish broad authority to correct all the ills in the world. But I happen to support Admiral Inman. It's an opportunity for us to carefully review this interdependency to make sure that we don't isolate some segment of the industry and distort the economics in that portion by its isolation. So we have to look at it broadly.

Senator **SANFORD**. Certainly there aren't several hundred industries that are absolutely vital to the ongoing defense of the nation either.

Dr. **COSTELLO**. That's true, but there are some industries that are vital to the Defense Department——

Senator **SANFORD**. There are several dozen in any event. Now it is incumbent on us to keep those industries strong within our boundaries in case we are at war. To take Senator Gramm's expression, this may be with us as long as the republic survives. Does the republic need the steel industry in order to survive and to have a strong defense? Can we dare let that go elsewhere?

Dr. **COSTELLO**. I support Secretary Carlucci, if I may be the first to answer part of that question. We no longer are the leaders in all technologies. We have to develop a way to bring new technologies from the offshore leaders to this country and we've been effective in doing some of those things. Protectionism could kill that off.

Senator **SANFORD**. I think you are defining fairly well what we need to do to protect the defense. I suppose the question comes back to, do we need to extend this act in order to achieve those goals or is there a better way to do it?

Mr. **CARLUCCI**. Senator Sanford, I think we need to extend this act, but I would argue strenuously against using it as a broad instrument to enhance U.S. competitiveness.

Senator **SANFORD**. Is there a danger that it's been used in that way?

Mr. **CARLUCCI**. No, it has not been used in that sense and I would simply urge that in extending it we avoid provisions that would broaden it so it could be used in that sense.

You mentioned the steel industry and I found myself wondering, "Well, in a weapons system, steel is only one of tens of thousands of components, and as a practical matter, it is impossible in today's global economy to keep every industry on-shore and to pick and choose." We've been required by the Congress to pick the 22 most critical, but a lot of other countries are ahead of us in some of those industries.

The **CHAIRMAN**. Would you yield just at that point on that question? I'm not here to make a case for the steel industry, but you were Defense Secretary and I can't imagine that you want to leave the assertion on the record that you could run a defense establishment in a modern age without domestic steel capacity, could you? Could we just ship it all in from somewhere else in an emergency 10, 12 or 15 years down the line?

Mr. **CARLUCCI**. Certainly as a matter of principle, I want to have——

The **Chairman**. I'm talking about not principle but practice. Don't you need steel to run the defense establishment?

Mr. **Carlucci**. But if I build a tank, Senator Riegle, and I have all the steel I need in that tank but I can't get the electronic components or the missiles——

The **Chairman**. You have to have them all, but are you saying to me you need the electronics but not the steel?

Mr. **Carlucci**. No.

The **Chairman**. You need them both.

Mr. **Carlucci**. I'm saying that as a practical matter it is impossible to protect them all. Therefore, I argue that the only way to go is international armaments cooperation with our allies. We cannot go the protectionist route and certainly in the high technology area we cannot be self-sufficient for long. We cannot exist, as I said in my earlier statement, on a boutique strategy.

TODAY'S ALLIES WERE YESTERDAY'S ENEMIES

The **Chairman**. Well, if you'll yield just a minute further, Senator Sanford, we've all lived through the period of time where today's allies were yesterday's enemies and let's hope that our allies stay our allies. But I'm old enough to remember and certainly you are too that I don't know that I really want to depend upon somebody else who may be an ally today and not an ally tomorrow on the critical items that make up the national defense capability.

Mr. **Carlucci**. I don't either.

The **Chairman**. But you just made that case.

Mr. **Carlucci**. No. I am saying we have to live in the real world. If you ask me what would my preference be as a former Defense Secretary, obviously it would be to have everything on-shore. But is that the real world? Is that practical today? My conclusion is that it is not practical. Therefore, we are better off going the route of armaments cooperation, working with our allies, getting the critical technologies, and being global in our defense industry.

I come back to some of the fundamental forces that have shaped our defense industry, such as the budgeting and programming process between the Congress and the Executive Branch, such things as multiyear procurement, buying at economic rates. There are a lot of things we can do to help that industry go global.

The **Chairman**. Well, I don't want to take more of Senator Sanford's time, but I'd like to see what the strategy is if you make the assumption that the steel industry moves offshore and suddenly you need a lot of steel you don't have. I'd like to see how you would get it in here, especially if you've got to buy it from the guy that's now your adversary.

Mr. **Carlucci**. I don't want to make that assumption, but I don't want to end up protecting the steel industry for our life time because it will surely lead to protecting every other industry and that will surely lead to retaliation and isolation and I argue that we cannot exist, either economically or technologically, in isolation.

The **Chairman**. You've been very generous.

Senator **Sanford**. I haven't really been very generous. The red light was on. But I certainly do thank you for this stimulating addition to our discussions and we look forward to reading more carefully your testimony. Thank you.

The **Chairman**. Senator Kassebaum.

Senator **Kassebaum**. Thank you very much, Mr. Chairman.

First, my apologies for coming in late. We had hoped to mark up the foreign aid authorization but there was not a quorum ever that could be present and I've been sort of reading through the testimony of all three of you because I think we are very fortunate in having such experts as yourselves comment on what I think is an enormously important subject and I guess much ground has been covered and I won't spend a lot of extra time.

TAKEOVER TREND ADDED TO PROBLEMS

I was struck, Secretary Carlucci, in a comment you have in your statement which I would assume all three of you might agree with. Basically, it was "failure to design for producibility and the short-term horizon of management driven in part by the takeover trend and an increasingly litigious society", among other things, have caused the problems that we have.

Would all three of you agree with that basically?

Mr. **Inman**. Yes.

Dr. **Costello**. Yes.

Senator **Kassebaum**. I would like to ask you if you feel that the takeover activity that we have seen has forced management to be short-sighted, has added enormous debt burden to industry, that has really caused them to look to the short term rather than the long term? And if this is the case, is there anything that we can do about it without causing perhaps more harm than good?

Mr. **Inman**. Senator Kassebaum, I've had 7 years now of the privilege of working in the private sector after long Government service, including involvement in the leveraged buyout status these last 2½ years. I'll have a lot more to say about that in a few months from experience. Let me say now that in those 7 years there were a good many annual meetings where I heard the shareholders complain about the price of a stock or the low dividend that had nothing to do with takeover. In fact, I never heard at one of those meetings where a company was losing money anybody commend the company's management for taking the long-term view.

The first board I joined, I went to an investment committee meeting where they examined the performance of the managers of the company's pension funds and complained about the performance on a quarterly basis and dropped one manager because they didn't have returns as high as the rest. I then went to the board meeting that followed and listened to the complaints that there was no loyalty in the ownership of the stock, that the stock all now held by large institutions and no longer the single individual investor. And I asked them, wasn't there a conflict in that? And they simply told me I didn't understand.

But the reality is, as we have shifted to a large pension fund ownership in a great many companies and they are purely looking for quarterly performance rates, that there are a great many things that have added to this short-term complexity.

I used to complain about going to so many committee meetings in Government and about how slow I thought Government was in performing. I have found to my dismay that industry replicates a good many of those things.

So the takeovers have added to the problem, but it has a far broader base than just the takeover part.

Mr. **Carlucci**. I would agree with that, Senator Kassebaum, and that's why I put in in the sentence "driven in part by the takeover trend and an increasingly litigious society." One can make the case for takeovers that that does keep management on its toes. We've all heard the arguments and I could make another argument that if you have a strategic buyer you can add to the capacity of the company. But pure takeovers for takeover sake do tend to shorten the time horizon and that has a harmful effect on our competitiveness, no question.

Dr. **Costello**. When Secretary Carlucci was leaving the Department of Defense, he and I had a confrontation on takeovers. I wasn't very happy with them. He said, "Bob, this is the first time we've had one of these arguments."

I don't think the takeovers themselves have been the cause of the short term view—I agree with the statements both of Admiral Inman and Secretary Carlucci. The short-term perspective has been there for a long time and I think if our business schools would start teaching long-term creation of wealth instead of short-term portfolio management, we might be way ahead.

Senator **Kassebaum**. Well, I don't know how this relates to the legislation that we have to consider before us in the DPA, but I think it is at the heart of the matter in many ways of our whole business climate today and the inability to stick with applied technology. The case that we all usually refer to is what happened to the VCR and the VCR industry in this country, when we simply were not willing to spend the time and effort and perhaps the long-range goals that we have to set out. And I think all three of you, from what I've read in the testimony, speak to better coordination to those priorities and the ability to stick with that over a period of time.

I don't know quite how we get to this. You can't legislate sometimes that kind of effort.

Mr. **Carlucci**. That's the problem. It's very easy to diagnose the problem. It's much harder to find a solution.

Dr. **Costello**. Several years ago I had an opportunity when I was in the electronics industry to give the passive components people an opportunity that was unique. Passive components are resistors and capacitors, most of which are now made in Japan or offshore. I said, "Here's a clean sheet of paper. I'll give you a billion-unit a year volume if you will work with me. I will not even talk to anybody else." They refused to come to the table. I was forced to go to Japan. Because of the short-term payoff.

They came back 3 years later and said, "How do we get into this business, Bob?" They have to take a longer-term perspective in the beginning. That's a major change and you don't legislate that, just as you don't legislate ethics or some of the other things that we try to do.

Mr. **Inman**. Senator Kassebaum, for another time, a fascinating comparison can be made between Japan and the United States on cost of capital and the approach that produces in the whole manufacturing cycle.

The Japanese frequently don't have the best technology on the first product where they aim to gain market share but they keep a cycle of change going and eventually get to the point where it's both the best product and it's very profitable.

We're driven toward a very different approach that says you borrow money, put in a production facility, and then go out for a pricing strategy to pay down that expensive debt and don't make any changes at all that would add to your costs.

Senator **Kassebaum**. My time is up. As a parting comment, I totally agree with Senator Gramm on education and the fact that we aren't really educating a skilled work force for the next decade either, and the importance of the vocational education as a component of teaching skills that are going to be important for the work force.

The **Chairman**. Thank you.

Senator D'Amato.

Senator D'**Amato**. Thank you, Mr. Chairman. I'm going to ask that my written statement be included in the record as if read in its entirety.

The **Chairman**. It will be.

STATEMENT OF SENATOR D'AMATO

Senator D'**Amato**. Mr. Chairman, I support your initiative in looking to the broader questions underlying the Defense Production Act. Like you I have been concerned for some time about the maintenance of a strong industrial base in this country for reasons of both economic and defense competitiveness.

The assumptions underlying the original 1950 Defense Production Act are clearly in question today. In 1950, the United States was the world's most powerful and most vibrant economy. Following World War II, America had a complete, organic industrial capability in place. The only issue was whether the President had sufficient authority to place it on a full wartime footing.

The question today is whether the United States has an organic industrial base capable of supporting the complex and comprehensive mission of the Defense Department. I commend you for assembling such a distinguished and eminently qualified panel of witnesses. I join you in welcoming them.

I add only this closing point. I think it is well accepted in U.S. military history that our wars have been won because of our fine soldiers, sailors, marines, and airmen. However, it is also widely recognized that America's industrial might has been an essential ingredient in every victory; therefore, a loss of a strong organic industrial base is a burden that we should never ask our armed forces to bear. We must not allow America to undergo "industrial colonization" by foreign concerns in technological areas which are critical to defense mobilization. To do so would be a dereliction of our duty as legislators and would leave the country in great peril.

Thank you, Mr. Chairman.

It's certainly a thought-provoking hearing, Mr. Chairman.

There's no doubt that unfettered protectionism is something that would pose a very real problem, and Senator Gramm articulated some of those problems.

By the same token, how do we deal with the foreign competition which has targeted key industries which does in its own very carefully orchestrated manner prevent legitimate competition, which subsidizes when necessary until it has obtained that market share that gives it preeminence or a dominance? And I would suggest to you that we've had one of the finest and most competitive industries in the machine tool and dye making area—hard working, small, productive companies, not the giants who became indolent or who became tied to contracts that didn't make sense because of union relations, et cetera. And they have been beaten down because they simply could not compete with many of the tactics that came from the foreign competition, driven primarily by the Japanese.

I've seen it and I've seen some of the finest companies finally close their doors because the cost of their doing business, notwithstanding the fact that every modern technique available to them was applied and every fine standard of production was put forth. They just lost market share, just could not compete, just were undercut, and finally faced a total dominance of the situation.

Now there are both sides. We don't want to have protectionism on one side because it then becomes the crutch upon which those—and I think Dr. Costello indicated they never want to throw that crutch away or are incapable, and the side that I think too many industries have found themselves.

What do you do? What's the answer? Is that really what we're talking about? How do you deal with it? Ball bearings today—is that essential to the defense industry? Don't we find ourselves in a situation where if we said to our U.S. manufacturers, "you have the totality," they couldn't even supply it. That makes Frank's point. They wouldn't be able to meet our needs.

DOD DEPENDENT ON FOREIGN IMPORTS

Mr. Carlucci. That is true and one could single out any number of areas where the Defense Department is dependent on foreign imports for critical components. So we are long past the point where we can institute a "Fortress America" concept.

I didn't hear anybody on this side of the table, Senator D'Amato, argue against vigorous trade negotiations. I am all in favor of negotiating just as hard as we can to create a level playing field. At the same time, we have to look at our own internal weaknesses and several have come out in this hearing—education being one, quality being another. I argued that the instability of the funding process in DOD is a third. The kind of management that we have in our companies may well be a fourth. I had a discussion with a prominent Japanese industrialist the other day, who by the way brought his company over here, set up five factories in an industry that they had knocked us out of and is now competing here in the United States with American workers and American management, and he said it's a question of management style and the kinds of people we put in the jobs. Well, that sounds awfully simple. I can't believe that it's the entire solution, but we have to begin to examine our own deficiencies in this process as well.

Mr. **Inman**. Certainly, predatory pricing is a problem government has got to deal with.

I have a sense that we can stockpile components, but there are basic things and a basic production capacity that you can't stockpile. Therefore we've got to be careful not to try to do too many things. I've seen some proposals from the other body that worry me, that they would take the act far beyond where I believe it ought to go. But I think, in response to Senator Sanford's question earlier, that we ought to reauthorize the Defense Production Act. And there are probably some areas where it can be improved in looking at how do we ensure we do keep some fundamental capacity in this country.

I, again with great reluctance, distance myself a little bit from Frank Carlucci on international cooperation. I certainly understand the necessity for viable weapons systems that are interoperable with our allies. It doesn't make any sense to deal any other way.

But as I look at this changing world and the speed with which it's changing, I'm not sure 20 years from now that some of these countries that are currently our allies by treaty will be in that same status. Therefore, I am reluctant to give up our capacity entirely. We can buy some weapons from foreign sources, but I would be very reluctant to go entirely to dependency abroad in a great many countries that are now economically capable of doing it.

Dr. **Costello**. Going back to the Senator's analogy of the machine tool industry, it's critical to us. We, in the Defense Department, when I was there—and Secretary Carlucci was there—we were extremely concerned about the impact on the Defense Department. We had a number of programs we put into place.

Our machine tool companies are relatively small. We said, "You'll have to get together in some unique way so you can do together what you cannot do by yourself." There's a Flint River project in Michigan that we helped along quite a way. Focus Hope in Detroit is another program we're helping along. There's a program in Western Pennsylvania in which machine tool companies have gotten together and put in facilities, flexible machine centers, that can be used 24 hours a day to meet the needs of 7 companies or so, but which not one of them could afford on their own.

Those kinds of initiatives are tough for that industry because they are all entrepreneurs. We acted as a catalyst and said, "That's the only way you're going to be competitive and be a technological leader and compete with that plant in Nagoya or wherever else it is that works 7 days a week, 24 hours a day, 52 weeks a year."

So those kinds of things are possible even with the laws that we have. But then we come back to SEMATECH and some of the other consortia. They are allowed to do R&D, but are they going to be allowed to make product and sell it? Because the manufacturing facilities are now so expensive we may have to come back to you and say, "Change the law." Those are the issues we've really got to take a look at.

Senator D'AMATO. Well, my time has expired. I would think, Mr. Chairman, that would be an area of crucial importance because so often we have been the technological leaders in advancing. I think sometimes we get down on ourselves about that but we lag in the production, the commercial application has been undertaken—whether it's the VCR that has been stated as the classic example, invented here and then perfected and brought out, or so many other of the patents and so many of the other products that have been developed here by American entrepreneurs and technological achievements and then expanded commercially by foreign competition. I would hope that we would be open on that and that you would keep in touch with us on the need for whatever legislative reform. It would seem to me a very great loss of a very vital sector of those who have been in the advanced stages of bringing these accomplishments to the area where now it's time to put up the dollars and to go forward with commercial application.

Mr. CARLUCCI. May I make a point for the record, Senator D'Amato, since I've come across as a free trader here. I do favor consortia such as SEMATECH. I think it's very valuable.

Senator D'AMATO. Frank, you notice I didn't take you up on the FSX. That took great restraint on my part.

Mr. CARLUCCI. I think the only difference between me and Admiral Inman is that he is worried about something that will happen and I think we are already there.

Mr. INMAN. He just told me quietly I've been gone 7 years, and am 7 years out of date.

The CHAIRMAN. Just to finish a couple of thoughts myself here, I think it's been an enormously valuable discussion today and we're opening up a topic here and perhaps this is as good a forum as any to try to get these issues out onto the table and connect all the pieces and start to think about the nature and shape of this puzzle.

I'd like to give you all a couple of additional thoughts and maybe a way to get at this question of how do we conceptualize this new problem and how do we then maybe think about moving into dealing with it.

I think if you look at our overall economic performance now, not only the industrial base and the defense base but the whole national economic performance, you see a lot of disturbing things. We've touched on a lot today. The low rate of productivity improvement and various other things.

U.S. TRADE DEFICIT BREATHTAKING

But fundamentally, we are consuming more than we are producing and you see that in the huge fiscal deficit. You see it in the huge trade deficit. You see this in the startling rise in our debtor nation status. We've passed everybody else on the debtor nation list. We're adding international debt right now at the rate of $1 billion every 3 days. It's just breath-taking. You put it on a chart and it looks like an airplane where the wings have come off and it's just headed down.

The New York Federal Reserve Board has estimated that by 1992 we're going to owe the rest of the world a trillion dollars net. That's how rapidly we're going into this debtor's hole. No one quite comprehends what this means. I've asked the smartest minds on Wall Street what the implications of that might be and they all scratch their heads and say, "We're not smart enough to tell you but it scares us to death and let's get off the trend lines."

In addition to those imbalances—and I think adverse and perverse trend lines, the things that we've talked about today, the cost of capital problem, the educational deficit that we have, the short-term trading impulses that cut against long-term investment, long-term production objectives and so forth. I think we've gotten a lot of the issues out on the table today.

But let me take all of that and sort of go to a point in terms of how we might think about deciding where we want to put the principal emphasis. We still haven't figure out the system by which we collect the right people to talk it through and reach some kind of a consensus judgment as to where we really want to put our blue chip effort. As a nation, I think we need to do that.

But I would suggest that another way to think about it is to look at our consumption patterns. In other words, what are the high value-added items that we are consuming that make up the lion's share of what it is that we're consuming each day. You've got McDonald's hamburgers down at one end and you've got the very high-priced, high value-added trucks, cars, buses, airplanes, defense equipment things and computers—things that are very, very expensive and very advanced and fall at the other end of the scale.

I think one useful way for us to try to use some logic to go through this problem is to try to look ahead and say what is likely to be our high value-added consumption emphasis over the next decade or two or three decades? Where are we going to be spending a large part of our national income?

Then to be sure that we are producing something, if not those things, something that's going to generate an equivalent value to be able to allow us to pay for the things that we want to consume that are very expensive because they are high value-added, costly items.

It may well be that we are just as well off to set ourselves up to produce a pretty good sized amount of the high value-added consumption that maybe we ought to be producing that ourselves. We can say let's let the Koreans do it or the Japanese do it, but then we'd better be sure that we are producing some high value-added item in roughly equal amount that they buy from us so that we've got an offset so that we're sort of maintaining a balance and we're not sliding into a competitive hole, which is what we've been doing.

Now that might be a way to do it that doesn't go to the question of winners and losers. I mean I understand that anxiety. I don't want to get into that problem either. But it seems to me if you just look in raw economic terms of where it is we are spending our resources, what is constituting the use of our national income, that probably those are the areas that we ought to make sure that we've got the ability to produce high value-added production in amounts roughly equal to what we're consuming. It may be the same items. If not, other items that could be an offset.

We don't think that way, and frankly, I think we're being pushed out of the high value-added production area steadily. You hear all the jokes about we'll end up pressing each other's pants down at a cleaning establishment or we'll end up as a nation of hamburger flippers and so forth and we're doing a lot of that these days. I don't demean those industries, but I don't think you can run a modern, national, leading Western nation if you start tilting your production base heavily in that direction. And our great success has been the fact that we had to tilt the other way. Certainly coming out of a General Motors type background—and all of you have had experiences that would bear that out.

So maybe a way to think about this is how do we incentivize by some means the state-of-the-art production of high value-added items that we're going to be consuming the next two, three or four decades as far up the line as we can see, and how do we make sure that we stay viable in those areas, because just as surely as the international competitive picture plays out, if I'm a strategist in Japan and if I'm part of MITI, I've got the tools and the ways to see those things and go and get those things and take them away from the United States or take them away from Great Britain or take them away from Brazil, I'm going to do it. And I'm not going to have any compunction about doing it because that's the international system and those folks—I don't just single them out, but they're exhibit A—are very, very good at it. We're not very good at it because we're not able to talk to each other. We're not able to think and operate in national terms because we're now in the situation where all the separate sort of disconnected decisions by themselves aren't sufficient in terms of adding them up to give us the kind of strategic competitive advantage internationally that we've got to have and we've got to have a new system of thinking about the problem and I think even making some of these major strategic judgments.

But in order to get out of the picking of winners or losers, maybe the way to do it is to be one step removed in terms of saying what are the items that cost $20,000 a unit or $50,000 a unit or $200,000 a unit, $5 million a unit, $25 million a unit, $50 million a unit; and how much of that do we consume and are we producing roughly an equivalent amount in those very high value-added, sophisticated, tend to be high technology kinds of products?

I don't think we are. I would just put that on the table as a supposition that there's a gap opening up there and I think that's where the foreign competitors are targeting, which is smart strategy for them. I think we are not doing much of that except for things like SEMATECH and sort of efforts to try and take and move into that gulf and try to create a partial answer and maybe a technique for a broader answer.

I think that's what we've got to get to discussion and we're going to have to think this through. This is a national debate that hasn't happened. We go through national Presidential elections and we don't really discuss this. We talk about the Boston Harbor and Willie Horton and a lot of other things—not that they're not part of the national debate, but the bottom line is that these issues by and large we don't get to because other things tend to dominate the discussion and these are a little complicated and so we don't really have a national debate and we just kind of roll along.

I would like your further ideas on those two questions today—the two questions being: What is the method by which we collect a discussion group or a decision-making body or a body that can think about how to frame this question of choices and how do we do it? How do we actually set up a way to talk to ourselves as a nation?

I still like the concept of Team America. I think one of the reasons we don't like the flag burned is we think it represents all of us and we ought to be able to work as a team and so I'm not troubled about that—private sector, public sector, academic people, labor and so forth. I think we ought to work as a team, think as a team. I don't think we should be adversaries. I don't think that's where our problem is. I think our problem is with external adversaries.

FUTURE PRODUCTION TO MATCH NATIONAL CONSUMPTION

Then the next question is, how do we fashion a strategy to make sure that we are producing in the future a national output that starts to match our national consumption? If there's a shortfall, particularly in the high value-added items, how do we go about adjusting that shortfall? Maybe part of it is consuming less, but if we're going to continue to consume the same amount, how do we set ourselves on a course to produce a dollar volume of output that can match what we're consuming so we're not just going into a debtor's hole?

I think if we can start to think that way we can start to move ourselves towards some choices here that maybe are a little more philosophically neutral because we don't need that debate. What we need is something that lets us perform as effectively in relative terms as the Japanese are performing or as the Taiwanese are performing or as the Koreans are performing or as any number of other countries are performing.

In fact, we have trade surpluses with so few countries these days, like Poland, for example, and the Soviet Union, who are hardly the models of efficiency in this day and age, but virtually everybody else has a trade surplus with us—and a substantial trade surplus with us. It's just incredible.

So I think we are living on borrowed time here. I don't think you can ride these trend lines indefinitely and in these large macro terms without having enormous shocks to the system come at some point. I don't want to see it from a national security point of view. I don't want to see it from an economic or national living standard point of view. I think the public sort of holds us and should hold us accountable because we're all people who operate at a level where hopefully we can sort of pull this thing into focus and think about what some of the judgments are that are needed.

In any event, I appreciate your patience in listening to my thoughts as I react to some of the things that you've said today and maybe we can press that discussion and go down that road some and I'd be interested in what further thoughts you may have beyond today.

Senator Roth has come in. Senator Roth, let me yield to you now.

Senator ROTH. Thank you, Mr. Chairman. I do have an opening statement which I would ask be included.

The CHAIRMAN. I have a statement from Senator Sasser and without objection it shall be inserted in the record.

STATEMENT OF SENATOR ROTH

Senator Roth. Mr. Chairman, the Defense Production Act of 1950 was enacted during the Korean war to provide statutory authority for the economic mobilization that was necessary to conduct the war effort. While seven titles were enacted, today only three survive, and they are due to expire on September 30, 1989. Thus these hearings are timely. I commend the chairman for scheduling them and for pressing forward in spite of the very heavy agenda of this committee.

It appears generally agreed that the three remaining titles—I, III, and VII—should be extended. There may be some disagreement over amendments that will be offered. The administration has offered some amendments to update and improve these titles, and I understand that members of this committee may be offering amendments, some perhaps more far reaching than the administration's.

There is little doubt in my mind that all Americans support economic mobililzation in wartime, such as that authorized by the DPA. But during peacetime most of us favor a free and open economy. In the long run, a free and open economy is more efficient and imposes smaller burdens on the taxpayer. We have only to look at the example of the Soviet Union to learn the lesson of what happens when you regulate a peacetime economy for wartime purposes.

Now, I can easily understand that the Defense Department would generally prefer to have a domestic source of supply. Likewise the domestic supplier would enjoy an additional Government contract. But what is good for the military-industrial complex is not always best for the American people. Military protectionism like economic protectionism has its costs—here, in higher budgets and the inevitable choice between higher deficits and higher taxes.

What is needed in this area is a proper balance of interests. We must be careful both in the definition of our terms and of our needs, lest wartime and war-preparation authorities be used to run large segments of our peacetime economy. I, for one, would not want the Government to run the electronics, semiconductor, or telecommunications industries because of their military importance.

I understand the fear that is felt as we find our country dependent on foreign sources to supply strategic materials and to finance our budget deficits. The proper response, in my opinion, is not to circle the wagons but to strengthen our economy. The importance of a strong economy to our national defense should not be underestimated. Our economy could be strengthened considerably by increasing the supply of savings to fund economic investment.

Congress has the power to move our economy forward. Instead, it has moved in the wrong direction. I hope that Congress will wake up soon and realize that to improve our competitiveness we should improve our savings.

That is a fundamental and necessary economic reform of course, such a reform would not be a panacea. There will always be specific defense problems that command special attention. That should be the role of the DPA. But, in my opinion the DPA is not the proper vehicle for general economic reform.

I am pleased to see, Mr. Chairman, that you have invited a distinguished panel of witnesses this morning. I look forward to their testimony.

Thank you.

STATEMENT BY SENATOR JIM SASSER

Senator SASSER. Today we will hear from a panel of experts on the Defense Production Act and our competitive position in defense industries. The testimony of Mr. Carlucci, Admiral Inman, and Dr. Costello will lend great insight into the problems that we now face with defense production and how to bolster our defense resources for the future. The issue of our international competitiveness, both in defense and other industries, is one of deep significance for ourselves and for future generations.

Our reliance on foreign capital has reached the level of some $10 billion per month in investment from abroad. Foreign investors are continuing to enter our market and take over the established industries that are the foundation of our defense industrial base and the industrial economy in general. At the same time, according to Mr. Inman's testimony, over 80,000 out of 118,000 domestic defense firms have left our defense marketplace during the period from 1982–87. I am greatly disturbed by these trends. Are we making it too easy for foreigners to "come in and clean our clock?"

Because of an amendment to the 1987 trade bill, the Defense Production Act gives the President the power to block mergers and acquisitions by foreign firms that are deemed to be a threat to our national security. With the internationalization of the marketplace and the tenuous state of our economy, I am concerned about foreign aquisitions generally—particularly hostile acquisitions of our established businesses. Last year I explored the issue of reciprocity of foreign hostile takeover regulations. I look foward to hearing our distinguished witnesses experienced views on the DPA and the overall issue of competitiveness today.

Thank you, Mr. Chairman.

Senator ROTH. Let me just make a couple of observations on what I understood the chairman to be saying.

The idea that we have to become self-sufficient concerns me. Isn't that somewhat inconsistent with our so-called liberal trade policy where each seeks to produce what it can produce best? Does economic interdependence lessen the threat of war? I'm not sure, but I'd be interested in your observations.

SOURCES OF CAPITAL AT COMPETITIVE RATES

Before I came here—and I regret I wasn't here earlier because I attended some hearings at the Finance Committee—I think you, Admiral Inman, made some statement that to compete we need more generous sources of capital. We must increase productivity. I agree with both those statements.

Moreover, as part of our effort, isn't it important that we begin to save more, not only from the point of view of reducing the deficit, but also to increase individual savings as a long-term source of capital? I'd be interested on all your comments on those points.

Mr. INMAN. Senator Roth, I had written down just five quickly—reliable source of capital, at competitive rates, a skilled and motivated work force, productivity, quality, and a strong science and technology base.

We do need a higher savings rate. As I look at other countries which have higher savings rates, tax policy does play a role.

I had thought I detected the beginning of a positive trend the last few years, but that now appears to have sort of stalled out this year. So it says to me there is more we need to do to get that savings rate up.

Mr. CARLUCCI. I would agree wholeheartedly with both you and Admiral Inman that the savings rate is absolutely crucial. In fact, I'm rather surprised it hasn't come up in this hearing earlier.

With regard to your earlier questions, I'm glad to have someone join me on this issue because before you came in Senator Roth, I was making the case that self-sufficiency might be desirable as a matter of principle, but it is really utopia in today's world. We are in a global defense environment. We have had a coalition strategy for 40 years. It's been a successful strategy.

Admiral Inman worries that some of today's friends might be tomorrow's enemies and surely we have to look at that. But I would argue strenuously that the forward-based deployments and the coalition strategy is the only way to go and that arms cooperation is a vital component of that strategy and what we can get out of it now with the increasing trend toward high technology weapons is technological flow from our allies. I don't like it any better than the next person that the Japanese may be ahead of us in a number of critical areas, but one way to help solve that problem is to further the cooperative relationship.

If we try to go it alone in areas where we are way behind with our inability to put long-term investment in these areas, we will surely lose. So I think cooperation among allies is the only way to go.

Senator ROTH. Well, I strongly agree with that. I think the biggest problem we face as a nation today is becoming competitive in this emerging global economy. If we avoid addressing that problem and seek self-sufficiency, I think we are placing our bets on the wrong concept. So it would deeply disturb me if we should go that direction. There are many things we have to do. I think in your statement you talked, Admiral, about increasing productivity, which again is based on savings.

I introduced a bill just a few weeks ago. I have been a strong supporter of IRA's. I think we took a step backward in 1986, and I voted against that tax legislation for that reason. But I've introduced a new bill which combines a number of features. Instead of getting the deduction at the beginning, you get the deduction when you withdraw. So that it doesn't have the budget effect now that it had, but it would have an incentive to save. We would also permit up to 25 percent to be withdrawn for the first purchase of a house or catastrophic insurance or sending a child to college. So it takes care of some of those contingencies.

Finally, we would give a 25-percent tax credit to those on the lower end of the economic scale to promote savings by the poor and the less affluent. That is important because one of the complaints about IRA's was that it benefited the middle class and more affluent.

But I really would hope that you, if you agree with me, would not only look at my specific proposal, but act. I think it's critically important that this country becomes a saving nation. So far the rhetoric is right but the action is poor.

Mr. INMAN. Senator Roth, I'm sure all three of us will indeed look with interest at that.

On your first part, capturing the need to assure the vitality of alliances, I'm in total agreement.

My argument is toward some hedging. What if they don't choose to remain our allies, if they don't choose to make the facilities available to us. I can chart half a dozen countries where I'm not sure that we're going to have facilities available in the middle 1990's that are absolutely essential to a forward deployed strategy.

So I am arguing a case looking at the pace at which this world is changing, that we don't put ourselves in a mode where, if someone else pulls the plug on an alliance, we find ourselves damaged without an ability to proceed on our own.

Dr. COSTELLO. I'd like to concur with your statements on savings and the statements both Admiral Inman and Secretary Carlucci have made.

But I also have concerns. As Admiral Inman has said, we had a recent case in which the last laser fab facility in the United States was sold to the Germans. I talked to the semiconductor leaders in the United States. One of them had his wallet stuffed with $270 million that he had just sold part of his company. I said, "Why don't you use some of that money to buy this unique supply capability?" He said, "I can't afford to, Bob. The rate of return is too low. I've got to pay 12 percent for my money." The equivalent rate of return for investment for the German was probably around 2 percent. We've got to level the playing field.

Senator ROTH. Absolutely. Well, my time is up and I regret that I wasn't here earlier. In closing let me just say, I greatly admire the public service of all three witnesses. One of my great concerns now is, whether we're going to be able to attract able people in the future with all the problems we're having on ethics and compensation. But thank you, gentlemen.

Mr. CARLUCCI. We all three agree on that issue.

Senator ROTH. Thank you.

Dr. COSTELLO. I have testified on ethics, recruiting and retention three times so far. Stressing the adverse impact of new and pending legislation.

Senator SANFORD. Thank you, Senator. You can see how many areas were opened up for discussion this morning. We have had a panel here of such a broad background that we talked about production and other aspects of competitiveness. I must admit I had two or three additional issues I wanted to raise. I've asked the leaders to set up a task force to develop a science policy that we've never had, I wanted to talk to the members of the panel but unfortunately our time has run out. Since the hour of high noon has arrived, I want to thank you very much for being here and this committee will stand in recess.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

OVERSIGHT HEARINGS ON THE CONDITION OF U.S. FINANCIAL AND INDUSTRIAL BASE

THURSDAY, JULY 13, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Sarbanes, Dodd, Dixon, Sasser, Sanford, Graham, Wirth, Kerry, Bryan, Garn, Heinz, D'Amato, Gramm, Bond, Mack, Kassebaum, Roth, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. Let me now move to the main order of business this morning with respect to our oversight hearing on financial services in the 1990's. I invite to the witness table at this time, Mr. Gerald Corrigan, who is the President of the Federal Reserve Bank of New York; Mr. Felix Rohatyn, who is the senior partner of Lazard Freres and Company of New York; Mr. John Reed, who is the chairman of Citicorp/Citibank of New York; and Mr. Jay Light, who is the senior associate dean at the Harvard Business School from Boston, MA.

I think the very substantial turnout of the people in the audience is some indication of the importance and the great interest there is in the subject we are about to take up.

We have had major financial services legislation pending now and we have acted on it previously in this committee, but it has not gone forward to final enactment because of difference with the House of Representatives or inaction in many cases by the House. So we have a number of very complex financial service issues that are before the country that this committee hopes to deal with and resolve.

Once we have made our way through the savings and loan conference report activity and have that legislation signed into law, we intend to move on into this area as quickly as we properly can.

This morning we have invited some of our top national leaders and thinkers in the financial services area to help us as we try to plan our agenda for future committee activities after the FSLIC legislation is completed. As the new chairman of the committee, my first priority has been to work with the administration on the thrift legislation and move forward on that rapidly. It's our intention to have that done prior to the August recess.

In the meantime, I am delighted that Mr. Corrigan, Mr. Reed, Mr. Rohatyn and Mr. Light have agreed to testify here this morning. I have specifically asked our witnesses to identify for the committee their view of the challenges and the problems facing the financial services community during the 1990's so that the committee may adequately discharge its oversight and legislative responsibilities. I have also asked them to advise us regarding how best to address the challenges that each identify, as well as to how to make our financial services sector more competitive internationally.

A number of the issues have been brought to the committee's attention for review, including the following: the health of the commercial banking industry, including banks' exposure to leveraged buyouts and to Third World debt, the health of the insurance industry and separately of credit unions, tender offer, leveraged buyout, and insider trading reform in the aftermath of the SEC's recent settlements and pending investigations, market reform in the aftermath of the October 1987 market break, the safety of junk bonds in a recession, Europe 1992, and the need for greater oversight of the accounting profession in light of its performance in the savings and loan crisis, just to name a few. There are many more issues that could go on the list.

We have given a lot of thought as to who we wanted to have as our witnesses today to really lay the foundation for this discussion that will lead to major legislative effort and action. So we have asked these particular witnesses because we thought this constituted the blend of expertise that would be the best beginning point in terms of laying these issues before the committee.

I'll just say one other thing. You will recall that when we started early on the savings and loan issue we had many, many days of hearings to lay the foundation, so we were in a position to act rapidly and wisely on that legislation. And I think as we now near the finish of that, it's very important that we get started on financial services modernization consideration and activity and that is really the purpose of laying this foundation today.

So I am very pleased that our witnesses are here. Mr. Corrigan, we've heard from you before. We have not had you yet before the committee as it's now constituted. We have some new members here. You will recognize some old faces and some new ones, but we are very appreciative of your presence and we'd like to hear your testimony. I'm going to call on Senator Garn, but when we begin I'm going to ask each witness to go ahead and we'll make the full statement a part of the record. Then I'd like you to give whatever summary remarks you wish and to go right to the high points of what you're presenting today.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator Garn. Thank you very much, Mr. Chairman.

I will be brief because there is not one of these witnesses who hasn't heard how I feel about this for the last 12 years and I'm not going to bore them or the members of the committee with going through my statements about modernization of the financial services industry.

Some years we would hold as many as 24 or 25 hearings on the subject and all of these gentlemen have testified before. But I would like to make just a very brief observation about the state of the financial services industry in the 1990's and beyond.

As we all should be very well aware, the world is getting a lot smaller. Transactions that used to take weeks now are a matter of seconds. As a matter of fact, I certainly learned how much smaller the world is getting when I orbited the earth every 1 hour and 32 minutes, but the financial services industry is even much smaller because of technology.

Vast sums of money move across national borders almost instantaneously with a telephone call, the touch of a button, a fax machine. The point is that we will increasingly have to take the global view when we talk about financial services matters.

Our national financial institutions have to compete on a global market and we simply can't afford to sit on the sidelines and watch the world go by. This global view demands that we engage in a major restructuring of our nation's financial system if we are going to be able to compete effectively in the global marketplace of the 1990's.

I am heartened to see that each of our esteemed witnesses agrees with this assessment and now if we could just get the House of Representatives to wake up and smell the coffee.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator DODD.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. Mr. Chairman, thank you, and let me first of all commend you for holding these hearings in the middle of the conference on the FSLIC crisis and with everything else going on. I think it's extremely important that we refocus our attention on the whole issue of financial services and obviously having these four witnesses is a very proper way to begin.

Senator Garn has indicated that this is not a new subject. It certainly is not. This committee went through a lengthy process last year on the bill and adopted it. We've waited over two congresses now. We have done our work over here pretty much, not to the satisfaction of everyone necessarily, but have worked on it, only to find that the House has not moved. So I'm hopeful we will come back to the issue again.

Again, I think the globalization issue is really a pivotal question and again our witnesses reflect that in their prepared statements this morning. We've discovered just in the brief hearings we've held on the securities industry and the market break in 1987 that the whole question of looking down the road of globalization of financial services is pivotal and you have to look globally. It came across loud and clear whether we're talking about capital standards or disclosure standards or clearance and settlement, bank powers. We've got to think out our own domestic regulatory impacts on institutions that participate in the global marketplace.

But I think Chairman Burns used to talk about the competition in laxity which is something of particular concern to me as we look at the regulatory scheme and our own domestic institutions in global markets.

Two areas that I would like to hear our witnesses address a little more in detail than they have in their statements. That is, one, systemic risk, which I think is extremely important. Mr. Corrigan discusses that in his statement. We learned obviously in 1987 that our markets are linked domestically and to a large extent internationally. That leads to the question of just how do we contain a major problem in one market before it spills over into other areas. I hope we will hear more on that.

What safeguards should be in place? What efforts should be undertaken to coordinate on an international level? What can the private sector do? And can government do something exclusively in this arena or should we basically keep hands off as we look at that question.

Second, the area of competitiveness of U.S. financial institutions, and again, I don't want to—sometimes there's an overemphasis on these comparative statistics and the statistics don't tell the whole story, but they do raise a matter of concern. Only three of the top 40 banks in the world in terms of assets are U.S. banks and only one of the top five securities firms in the world in terms of capital is American. And when the equity capitalization of the Tokyo Stock Exchange now exceeds that of New York and London combined, that's a cause for alarm in this country. At least I believe it ought to be. And the question is maybe it's causing too much alarm. If so, what should we be doing about it? We discussed this at some length in the subcommittee hearings but certainly we ought to revisit it here this morning as well. Obviously there are a number of proposals on financial services. I introduced, along with others, Mr. Chairman, the so-called Bob Liten approach, the narrow or safe bank approach. I would be very interested in hearing you comment on that. Mr. Reed, we missed each other in trying to talk about the Third World debt and Mexico and the discussions last month in Madrid, but obviously I'd be interested in hearing this morning how those are going.

Mr. Chairman, I know that's not exactly the theme of today, but how the negotiations are going with the private banks and particularly in Mexico. So if you might comment on that as well, please.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Dodd.

I know Senator Gramm has asked to be recognized.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, I thank you for recognizing me. I want to be brief because I want to use my brief time to talk about a circular that is being mailed to members of the Senate and House that claims to compare the two proposed methods of funding the savings and loan bailout. It claims that the Bush method, which it calls "a scandal and a ripoff" costs $335 billion and that the alternative costs $100 billion, and then when you read the fine print you find the alternative calls on the savings and loans to put up one-third the amount they do under the Bush plan and it calls then for a tax increase of $45 billion that they suggest include raising marginal tax rates on the richest of the rich to 33 percent, increasing the alternate minimum corporate income tax rate from 20 to 25 percent, taxing interest income on foreign investment, which would be a great move in terms of helping our financial stability; and eliminating deductions on luxurious second homes.

Now, Mr. Chairman, I'm not claiming that this is your intent, but I think it's interesting to look at people who are out trying to market the alternative to see that they clearly have two agendas. One is to reduce the amount that the savings and loan industry has to put into this thing, and second, to raise taxes.

I thank the chairman for his indulgence.

The CHAIRMAN. Senator Sarbanes wants to make a brief comment.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Mr. Chairman, I am anxious to hear this panel and I just want to commend you for this hearing and also for having such an outstanding panel at the outset.

Hopefully I will be here when my time for questions comes and since you can around here use your questions for any purpose you deem appropriate under the circumstances and since we have Mr. Corrigan and Mr. Reed here who have been very much involved of the question of Third World debt, I just want to forewarn them so they can start putting it in the back of their minds that my questions may in fact go off into that arena.

The CHAIRMAN. Do other members wish to be recognized for an opening comment?

Senator Sanford.

Senator SANFORD. Well, we're going to have considerable interruptions today I'm afraid with voting on amendments and I'd like to put my statement in the record.

The CHAIRMAN. We will make it part of the record.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you Mr. Chairman. I appreciate your calling for this hearing, and would like to welcome our very distinguished panel of witnesses and to thank them for their insightful testimony.

As you, Mr. Chairman, and other members of this committee struggle to complete work on the FSLIC reform legislation, I must say it is exhilarating to move on to some of the additional challenges that face us as we begin to craft a regulatory scheme for the financial services industry of the 21st century. I think this committee must take action to modernize the laws governing our financial system, both to allow our institutions to compete effectively in the sophisticated global market of today and to ensure that the increased risk to our financial system brought on by the overleveraging of corporate America and our tremendous budget deficit can be safely managed.

I share the concerns expressed by a number of our witnesses regarding the increased fragility of our markets caused by our excessive use of debt, and the increasingly short-term focus of our corporate institutions. We simply cannot continue to leverage ourselves to the hilt, dependent like drug addicts on a "daily dose" of foreign credit to finance our budget deficit. I am particularly concerned about the effects of our staggering Federal deficit on the cost of capital that must be borne by corporations seeking to modernize, improve or expand their operations. If the cost of capital faced by American firms remains significantly greater than capital costs elsewhere in the world, I see little hope that we can regain the competitive edge we need to climb out of the black hole of our trade deficit.

Fortunately, the experts before us today have put forward a number of bold ideas for addressing some of these problems. If the moratorium contained in the Competitive Equity Banking Act was enough to hold this committee's feet to the fire to get financial services reform legislation moving, then surely the threat of fortress Europe, or the possibility of a call for reciprocity in financial services by 1992, should drive us toward completing the restructing we fought for last year. I think our witnesses present a compelling case for the need to bring our financial services regulation into line with the global, securitized markets of the modern era as well as the need to take crucial steps to revise, or at least slow the trends toward the replacement of equity with debt, excess speculation in our capital markets, and increasingly slim capital cushions for ever more risk seeking institutions.

I look forward to hearing the testimony of our distinguished guests as we explore these issues.

I'd like to look at the long-range trends, but I think also several of you mention some of the things that are more immediate—the reduction of equity in debt and takeovers and leveraged buyouts and cost of capital and how manufacturers and business people compare and probably because of our great Federal deficit, and these are things that we have to do immediately.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Sanford.

Does anyone else seek recognition? Senator Graham.

OPENING REMARKS OF SENATOR GRAHAM

Senator GRAHAM. Mr. Chairman, I'm sorry that Senator Gramm has just left because I would like to put on the record that there are many of us who support the position of financing the savings and loan matter for reasons other than those two that he cited because we believe it is the honest approach and the less expensive approach, but this is not the forum to debate that issue.

Senator GARN. If the Senator would yield, this is not the on-off-budget. This is an entirely different plan. I just wanted to make that correction. He was not talking about the House plan versus ours. This is an entirely different way-out proposal with a $45 billion package.

Senator GRAHAM. In any event, it was irrelevant to the discussion today but I did not feel it appropriate to let even an irrelevancy pass unresponded to.

The question that I'm going to be particularly interested in is the role of reform of the financial services industry in the context of how do we stretch the timeframe in which economic judgments are made in our Nation. I have a sense that one of the fundamental issues plaguing our country is the shorter and shorter period in which economic judgments are evaluated and a whole series of negative consequences which flow from that. I'd be interested in exploring what impact your recommendations might have on stretching that timeframe for evaluation.

The **CHAIRMAN**. Any one else? Senator Pressler.

Senator **PRESSLER**. Mr. Chairman, I have no statement.

The **CHAIRMAN**. Any other member want to be recognized here?

Senator **WIRTH**. Mr. Chairman, I just want to thank you for having this hearing and welcome our distinguished witnesses. Mr. Corrigan and Senator Graham and I have worked on the whole payments system set of issues and the imagination that you've shown, sir, is very creative. Mr. Rohatyn is certainly well known to all of us and one of those people who is always impeccably honest and impressively honest as we face some of these extremely difficult situations. We thank you very much for coming.

Thank you very much, Mr. Chairman.

The **CHAIRMAN**. Thank you, Senator Wirth. I have statements from Senator Dixon, Sasser, and Shelby for insertion in the record.

STATEMENT OF SENATOR ALAN DIXON

Senator **DIXON**. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee considers our future in the financial services area. We have a very good group of witnesses before us this morning, and I look forward to their testimony.

Technological and marketplace changes, including the globalization of the marketplace, have caused a revolution in financial services. The question of whether we need a similar revolution in the law that governs financial services can perhaps be argued, but there is no doubt that the law needs fundamental reform. Unfortunatley, in many areas, our financial services law is no longer relevant to the situation we are facing. And because Congress has not responded to huge changes that continue to occur, all the halting efforts toward reform have been led by the regulators and the courts.

It is long past time for us to begin to act. We must begin to make a start. That is why I have introduced S. 305, the Proxmire Financial Modernization Act of 1989. My legislation is virtually identical to the bill that was reported in this committee by an overwhelming 18 to 2 vote last year, and which passed the Senate by an even more overwhelming vote of 94 to 2.

This is a carefully crafted bill, and its overwhelming acceptance in the Senate demonstrates that Senators know we must begin the reform process. Given the crisis that has occurred in the thrift industry, the legislation now in conference must be our first priority. However, we must go back to the banking law reform process just as quickly as possible. We cannot afford to let another Congress go by with no action.

S. 305 gives us a way to act, and act quickly, after we conclude action on the thrift legislation. I urge my colleagues to work with me and all the other members of this committee that were so instrumental in crafting this bill to see that it is quickly enacted into law.

STATEMENT OF SENATOR JIM SASSER

Senator **Sasser**. Mr. Chairman, today we will be discussing an enigmatic but exceedingly important subject—the future of our financial services in the 1990's. We have before us an impressive group of witnesses, all of whom are experts in various facets of the financial services field. Our financial services industry and its role in our overall economy is a topic of great interest to me.

Our economy is changing. No longer is our stock exchange preeminent in the world market. Japan is giving our securities firms a run for the money. The emphasis in finance has shifted from equity to debt. We are more concerned about the short run and instant profits than long-term stability.

The individual investor has become intimidated by the stock market, and the institutional investor—whose primary interest is in short-term profit—had come to dominate. The corprate takeover craze is continuing to create massive amounts of debt and to wreak havoc on the stability of established businesses. The increase in corporate and household debt, coupled with a significant drop in the individual savings rate has created a faultline in the underpinnings of our economy.

And finally, an issue of critical importance to the financial service industry is the Glass-Steagall Act. I am convinced that the Glass-Steagall Act has served our country well over the past 50 years. However, as I have outlined, times have changed and our financial industry is vastly different now than it was in 1932. We need to look beyond Glass-Steagall to an integrated worldwide economy and the type of structure in financial services that will do the most to bolster American competitiveness. I look forward to this morning's testimony on all of these topics with great interest.

STATEMENT BY SENATOR RICHARD SHELBY

Senator **Shelby**. Mr. Chairman, I would like to commend you for scheduling this hearing. The course of the financial services industry is an issue of great interest to this committee and of great importance to this country.

Nations and their economies are no longer isolated or independent but are inextricably linked through trade and investment relationships. Communications and information systems facilitate these relationships, making it impossible to turn back the clock.

The U.S. financial system must remain competitive if the United States is to remain dominant in this global marketplace. Yet the financial services industry remains hamstrung by archaic statutes still on the books. Last year, the Senate passed sound legislation to restore competitiveness to the financial services industry but the House refused to follow the Senate's lead.

Today, as we see Europe preparing for 1992 and Japan seeking to modify its form of Glass-Steagall, we must acknowledge that the issue of competitive equity has passed beyond the borders which were set out in last year's legislation. It is time to reevaluate the way in which we segregate various sectors of the U.S. financial services industry. In doing so, we must consider smaller parochial concerns against the larger backdrop of international competitiveness.

I am interested in the testimony of today's distinguished panel of witnesses. These gentlemen can provide us with valuable insight into the direction that we must permit the financial services industry to follow; I have read their testimony and found it very informative.

I regret that an important markup in the Armed Services Committee makes it impossible for me to attend this morning's hearing. My staff is in attendance and I look forward to her report on the comments made this morning.

Thank you, Mr. Chairman.

The CHAIRMAN. We are going to begin, Mr. Corrigan, by hearing you at this time.

STATEMENT OF F. GERALD CORRIGAN, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. CORRIGAN. Thank you, Mr. Chairman.

Let me first say that I, if nothing else, want to convey in the strongest way I can the sense of urgency that I think was reflected in your letter of invitation, and to join other members of the committee in congratulating you for having these hearings in such a timely fashion.

What I've done, Mr. Chairman, is prepared a statement and attached a number of appendices to it which I would like to have accepted into the record.

The CHAIRMAN. We will make those a part of the record.

Mr. CORRIGAN. In the interest of time I'd like to summarize some of the principal comments in my prepared statement.

FOUR PRINCIPAL PRIORITIES

What I've tried to do, Mr. Chairman, is to condense the agenda for the committee, as you have put it, into four principal priorities as I see them.

The first of those priorities is the very pressing need as I see it for this nation to do its part in reducing the sizable macroeconomic imbalances we have on a global basis. In suggesting that, I go on to say—and this I do want to repeat—why I think that objective, while clearly important in its own right, is so important in the work of the committee. I suggest several reasons for that.

First, in my judgment, there is no question that the current imbalances in the United States and global economy contribute importantly to the volatility we see in financial markets and that that volatility can be the source of dangerous elements of risk, including Senator Dodd's systemic risk.

Second, I suggest that so long as the budget deficit is so large relative to domestic savings, we are in effect hostage to the willingness of foreigners to plug our savings gap at interest rates and exchange rates that are otherwise compatible with satisfactory overall economic performance.

Right now, as we all know, that process is going relatively painlessly. But it's not always been that way and there is absolutely no assurance that it will always be that way in the future.

I next point out the high savings rate and the large current account surpluses in a number of other countries are in my judgment major factors contributing to the increased importance and enhanced competitive position of their financial markets and institutions.

Finally, and I think this is quite important, I am also convinced that a major factor in explaining the high cost of capital in the United States relative to Japan and Germany is also to be found in patterns of macroeconomic performance here in the United States.

COMPREHENSIVE OVERHAUL OF THE FINANCIAL SYSTEM

The second priority I cite, Mr. Chairman, is what I call the compelling need to proceed with the prompt, progressive, and comprehensive overhaul of the basic structure of our banking and financial system. My views in that regard have not changed materially since I appeared before this committee a couple of years ago in the context of my paper on "Financial Market Structure—A Longer View."

While the broad thrust of my thinking has not changed, there is very much a sense of greater urgency as I see it. The reasons for that greater urgency are rooted in market developments here and abroad which have important implications for the competitive position of U.S. firms and U.S. markets and for the manner in which we and others seek to formulate effective supervisory and prudential policies. Indeed, looking around the globe, it is now quite clear that the interrelated forces of technology and financial innovation are rendering segmented financial systems like our own increasingly obsolete. Indeed, in virtually all other major industrialized countries, the clear trend is toward more integrated financial institutions with elements of commercial banking, securities activities, investment banking, and to a limited but growing extent insurance activities coming under the same roof.

The only major exception to that is in the United States and Japan. But even in Japan, serious consideration is now being given to the substantial liberalization of Article 65, the Japanese version of Glass-Steagall.

Now as all of this occurs, not only do we in my judgment run the very troubling risk of losing competitiveness, including the loss of jobs, income and tax revenues in our major financial centers such as New York, Chicago or San Francisco, but we also run the risk of fostering unnecessary and potentially dangerous political tensions concerning the rights and privileges of institutions to operate freely in foreign markets.

For example, I am very encouraged by the recent steps taken in Brussels to respond constructively to expressed concerns about the reciprocity provisions in the European Community banking directive, but I am also certain that difficult problems lie ahead so long as the basic structure of our system is so different than most others.

Now this, Mr. Chairman, is not to suggest that we or any other nation should compromise our basic national goals and priorities in the name of a cookie-cutter approach to financial structure dictated by international considerations, but it is also to say we should not ignore those considerations.

MODIFY SUPERVISORY APPROACHES

My third priority gets to the matter of how do we modify supervisory approaches and the so-called safety net to the needs of today and beyond?

I suggest in my statement that as a matter of necessity we cannot really approach the question of reordering responsibilities among the agencies until we get the structure right itself. But I do cite several things that I think are very important in terms of the direction of our thinking in this interim period.

First, in my judgment, we should operate on the assumption—whether it's right or wrong—the assumption that systemic risk considerations are even more important than they once were.

Second, very strong capital positions for individual institutions, but especially major institutions, are an absolute must. To put it bluntly, there is no banking system, no supervisory system, nor any safety net that can compensate for weakly capitalized institutions except at major costs to the society at large.

To put it differently, we simply cannot tolerate a system in which the incentives work to maximize profits and socialize losses.

Third, the Federal Reserve, as the nation's central bank, must in my judgment remain a prominent part of the supervisory process. I raise that question today, Mr. Chairman, because every now and then I hear the suggestion that the Federal Reserve should tend to monetary policy and leave the supervisory business to others. I also raise the subject gingerly because I know there are those who will suggest that I am motivated by turf or institutional self-interest considerations. And I know for those who are inclined to that view there is probably nothing I can say to change their minds. But what I can say is that from my perspective, the relationships and the linkages between monetary policy and financial stability are profoundly important and ultimately inseparable.

Moreover, if the Congress and the public at large expects that the Federal Reserve will continue to play a constructive role in dealing with financial problems when they arise, we must have the tools.

My fourth priority I will not go into great detail on, but I think it's very important. That is to clarify our thinking on the subject of firewalls, corporate separateness, and all the rest of it. In the context of that, I do say, among other things, Mr. Chairman, that maybe—just maybe—we have to begin thinking in terms of something that leans in the direction of the so-called universal bank model.

I would also say that from my perspective we have to recognize, again from a systemic risk point of view, that the dangers of a sudden and uncontrolled failure of a large nonbank financial firm are just as great, if not greater, than that of a bank.

My last priority essentially deals with the subject of harmonization. I will not go into that right now.

But I would close by saying, Mr. Chairman, that much is at stake here, not only for our financial institutions and markets, but for our national well-being more generally. The longer we fail to forge a coherent approach to these problems, the greater the danger we will find ourselves scrambling for ad hoc solutions in a less hospitable environment than we face today. Thank you.

[The complete prepared statement of F. Gerald Corrigan follows:]

FOR RELEASE UPON DELIVERY
EXPECTED AT 10:00 A.M. EDT

STATEMENT BY

E. GERALD CORRIGAN, PRESIDENT

FEDERAL RESERVE BANK OF NEW YORK

BEFORE THE

UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING,

AND URBAN AFFAIRS

JULY 13, 1989

Mr. Chairman and members of the Committee; I am pleased to have this opportunity to appear before you this morning. The issues raised in your letter of invitation are of great importance now and well into the future. Not surprisingly, they are also exceedingly complex and do not lend themselves to a simple synopsis in the form of an opening statement. Therefore, I would propose to confine my prepared statement to an overview of the key priorities facing the Committee as I see them. However, I have appended to this statement several earlier public statements of mine -- together with some statistical materials -- which relate to the subject matter at hand, and I would ask that they be included in the record.

At the risk of an obvious oversimplification I believe the issues before the Committee in seeking to shape its agenda can be viewed in the context of four central priorities and my statement will proceed accordingly. In speaking to these issues, Mr. Chairman, I want to convey a sense of urgency which is rooted in my conviction that failure to come to grips with these matters in a prompt and progressive fashion entails unacceptably high risks of major difficulties at some later date. I also want to be clear that the views I will express today are my own and should not be attributed to the Federal Reserve Board or the Federal Reserve more generally. Let me now turn to the four priorities.

The first and most important is that we, as a nation, must get on with the very pressing task of narrowing and eliminating the very large and persistent macro-economic imbalances which, in my view, constitute a major threat to our economic and financial well-being over time. By macro-economic imbalances I mean, of course, the sizable and inexorably interrelated gaps between what we import and what we export, between what we consume and what we produce, and between what we save and what we invest.

Most would accept at face value the importance of eliminating these imbalances over time, but some might ask why it is so important in the specific context of the well-being of our financial markets and institutions, including their international competitiveness. As I see it there is a very direct connection between these macro-economic imbalances and the issues immediately before the Committee.

I say that for the following reasons: first, there is no question in my mind that the current imbalances in the U.S. and the global economy contribute importantly to the volatility we see in financial markets. This volatility can be the source of dangerous elements of risk -- including systemic risk -- to financial institutions and markets. Second, so long as the budget deficit is so very large relative to domestic savings we are, in effect, hostage to the willingness of foreigners to plug our savings gap at interest rates and exchange rates that are otherwise compatible with satisfactory overall economic and financial performance. Right now that process is proceeding in a relatively easy and painless fashion, but it has not always been that way. More to the point, there is absolutely no guarantee that it will stay that way in the future. Third, the high private savings rates and large current account surpluses in a number of other countries are a major factor contributing to the increased importance and enhanced competitive position of their financial markets and their financial institutions.

Finally, I am also convinced that a major factor in explaining the high cost of capital in the United States relative to Japan and Germany is to be found in patterns of macro-economic performance here in the U.S. Needless to say, those differences in the relative cost of capital have very important implications for the well-being and competitiveness of U.S. business enterprises, financial and nonfinancial alike.

Let me elaborate briefly on this latter point. There is a widespread perception that the cost of capital in this country is higher than it is in Japan and Germany and that these differences are importantly related to tax rate and/or tax structure considerations. Based on work we have been doing at the Federal Reserve Bank of New York, it appears that the cost of capital in the U.S. is indeed high, but tax considerations are not the principal explanation. More specifically, the pronounced difference in the cost of capital seems to be importantly rooted in (1) differences in private savings rates and (2) higher risk premiums in the United States due to (a) greater volatility in macro-economic performance and (b) higher and more volatile rates of inflation. This is not to say that other factors -- including tax considerations -- do not matter in explaining differences in the cost of capital. But, it does suggest that the emphasis that is often placed on tax policy as the major or dominant factor in explaining these differences is misplaced. As always, at the end of the day it is the economic fundamentals that really matter.

My *second* priority relates more directly to matters within the purview of this Committee. That second priority is the compelling need to proceed with the prompt, progressive and comprehensive overhaul of the basic structure of our banking and financial system. The Committee is familiar with my views on this subject as set forth in my January, 1987 essay on *Financial Market Structure: A Longer View*. Earlier this year, in addresses before the New York State Bankers Association and the Institute of International Bankers I attempted to take stock of the progress that has been made in moving toward a more coherent, a more competitive and a more stable banking and financial system over the past two or so years. My conclusion, unfortunately, was that on balance we had not made much progress, and from an international perspective we probably had lost ground.

The main thrust of my own thinking on this subject has not changed materially since my 1987 appearances before this Committee. For example, I still believe that the guiding principles and broad approach to reform outlined in my 1987 essay remain essentially valid today. Similarly, I remain of the view that structural reform of the banking and financial system must be accompanied with adaptations and enhancements of the supervisory process -- a subject I will turn to shortly. Finally, I remain convinced that sound public policy demands that we strongly resist structural arrangements -- whether they materialize by design or by accident -- that would permit banking institutions having access to the public safety net to be owned and controlled by commercial concerns. If anything, recent developments -- including experience with segments of the thrift industry --have reinforced my belief in that regard. The reasons why I have such strong views on this subject are outlined in an excerpt from my June, 1987 statement before this Committee which is also appended to this statement.

While the broad thrust of my thinking about structural reform of the financial system has not changed, my sense of urgency about the task has grown. The reasons for this are rooted in market developments here and abroad which, in turn, have important implications for (1) the competitive position of U.S. firms and U.S. markets and (2) the manner in which we and others seek to formulate effective supervisory and prudential policies. Looking around the globe, it is quite clear -- especially in wholesale banking and financial markets -- that the interrelated forces of technology and financial innovation are rendering segmented financial systems, such as we have in the U.S., increasingly obsolete. Indeed, in virtually all other major industrialized countries the clear trend is toward more integrated financial institutions with elements of commercial banking, securities activities, investment banking and, to a limited but growing extent, insurance activities coming under common ownership and control. The only major exceptions to this trend are in the U.S. and Japan, but even in Japan serious consideration is now being given to the substantial liberalization of Article 65 -- the Japanese version of Glass-Steagall.

As all of this occurs, not only do we run the very troubling risk of losing competitiveness -- including the loss of jobs, income and tax revenues in our major financial centers such as New York, Chicago, and San Francisco -- but we also run the risk of fostering unnecessary and potentially dangerous political tensions concerning the rights and privileges of institutions to operate freely in foreign markets. For example, while I am clearly encouraged by the recent steps taken in Brussels to respond constructively to expressed concerns about the reciprocity provisions in the European Community banking directive, I am certain that difficult problems lie ahead in this area so long as the basic structure of our system is so different from most others.

This is not to suggest that we -- or any other nation -- should compromise basic national goals and priorities in the name of a "cookie cutter" approach to financial structure dictated by international considerations. That would be neither desirable nor appropriate. On the other hand, it would be equally undesirable and inappropriate to ignore developments in the global marketplace which have a direct impact on the prospective well-being of our financial markets and institutions. We can and must adapt our system in ways that are broadly sensitive to market developments while still consistent with our own national priorities, traditions and culture.

My third priority relates to efforts to further modify supervisory approaches and the so-called safety net more generally to the needs of the day and beyond. At the heart of this issue is, of course, the very delicate balance between the dictates of a competitive, efficient and market-driven financial system on the one hand and the preservation of a safe, sound and stable system on the other.

In approaching this task, we must keep in mind an important practical constraint; namely, it is impossible to conceive of an effective and durable approach to the re-structuring of supervisory responsibilities among the various agencies unless and until we have come to grips with reform of the basic structure of the financial system itself. While the specific task of reshaping the structural approach to banking and financial supervision must, therefore, go onto the back burner, we do need a vision of what is important as we fashion policies in the interim, and as we seek to adapt our attitudes to the needs of that broader and longer term goal. Several things strike me as important in this regard. They are:

> First, in my judgment we should operate on the assumption that systemic risk considerations are even more important than they once were if only by virtue of the volume, speed and complexity of financial transactions and the related far-reaching operational, liquidity and credit interdependencies between financial markets and institutions nationally and internationally. The fact that monetary policy now works mainly through interest rate and exchange rate channels -- as distinct from de facto credit rationing devices -- only reinforces my belief in this regard.
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> Second, very strong capital positions for individual institutions -- especially major institutions -- are an absolute must. To put it bluntly, there is no banking system, no supervisory system nor any safety net that can compensate for weakly capitalized financial institutions except at major costs to society at large. Stated differently, we simply cannot tolerate a system in which the incentives work to maximize profits and socialize losses.
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> Third, the Federal Reserve, as the nation's central bank, must remain a prominent part of the supervisory process. I raise that subject today because every now and then I hear the suggestion that the Federal Reserve should confine itself to monetary policy and leave the supervisory business to others. I

also raise the subject gingerly because I know full well that there are those who will react to my statement by suggesting that it is motivated by turf or institutional self-interest considerations. For those who are inclined to that view I suspect there is nothing I can say that will change their minds. What I can say, however, is that from my perspective the relationships and the linkages between monetary policy and financial stability are profoundly important and ultimately inseparable. Moreover, if the Congress and the public at large expect that the Federal Reserve will continue to play a constructive role in helping to cope with financial problems when they arise, the Fed must continue to retain the tools, including on site examination authority, necessary to do that job well.

Fourth, our system of official oversight must be predicated on the principle of consolidated supervision, including supervisory oversight of holding companies. This is a well established principle on a global basis as it pertains to banking institutions. However, here in the U.S. and to a degree elsewhere, that principle is not followed for securities firms and investment banks. Moreover, there are those who would view firewalls as a substitute for consolidated official oversight. I simply do not share that view. Therefore, I believe we must -- for both competitive and prudential reasons -- clarify our thinking on the subject of firewalls and corporate separateness.

As the Committee knows, I have always taken the view that firewalls can serve a useful and necessary purpose. They help protect against unfair competitive practices; they help guard against conflicts of interest; they help protect the integrity of the deposit insurance system and the safety net more generally, and they help to facilitate a system of functional

supervision. Having said that, I have also consistently maintained that, in practice, when the temperature goes up the firewalls tend to melt. I have further maintained that insofar as the marketplace is concerned, in times of stress, firewalls become something of a fiction. Never was that more clear than at the time of the October 1987 market break. In that setting, when questions arose in the marketplace both here and abroad about the creditworthiness of individual firms those questions pertained to the company as a whole with almost total disregard for the niceties of corporate structure.

If that is a reasonable description of the realities of the marketplace, then it seems to me to follow that we must be prepared to think about two possibilities which lie well outside the bounds of conventional thinking in this country. One possibility is that we try to recondition attitudes in the marketplace to accept a legalistic view of absolute corporate separateness. That, however, strikes me as wholly impractical, especially since it would have to be achieved on a global basis to be effective. Indeed, leaving aside completely the question of whether CEO's and boards of directors are prepared to accept this view of the world, I know for a fact that authorities in many other countries simply do not look at things in this manner.

The other possibility is that maybe -- just maybe -- we have to begin thinking in terms of something that leans in the direction of the so-called universal bank model. Having said that, let me hasten to add that I'm not stating a conclusion. But, I would be less than candid if I did not acknowledge that I now give this possibility more serious thought than I once did.

That brings me to another controversial subject. Namely, of all the public policy considerations relating to the operation of the banking and financial system, the greatest concern is that of systemic disruption or failure. Having said that, let me now say quite directly something I have hinted at in the past. That is, the potential systemic damage growing out of the sudden and uncontrolled failure of a large, globally active non-bank financial firm can be just as great, if not greater, than the damage that can arise from the demise of a large, globally active banking firm. Indeed, this can be true even for some smaller firms. However problematic that view may be, it is, in my judgment, the reality. In turn, it is one of the reasons why I believe that the principle of consolidated supervision -- which, among other things, fosters centralized systems of risk control and management -- is so important. More generally, the systemic risk phenomenon also needs to be taken into consideration in the context of the national debate on financial structure.

In closing, Mr. Chairman, I have a fourth priority I want to comment on very briefly with a view toward getting the subject on the table rather than offering any hard suggestions. That fourth priority is that we do all we can to move more fully and more forcefully in the direction of greater coordination and harmonization of supervisory and prudential policies both domestically and internationally.

This call for greater harmonization obviously applies to the basics of financial structure as well as to central elements of prudential policies such as capital standards. But, it applies in other areas as well. For example, I place great importance on what I call the "plumbing" of the financial system -- the day-to-day, hour-by-hour, and minute-by-minute workings of payment, clearance and settlement systems. While it is not fundamentally a legislative matter, seeking to extend efforts aimed at coordination and harmonization to encompass operational policies and practices that relate to key elements of the "plumbing" of the system strikes me as an important

objective in its own right. Over the past several years -- perhaps especially in the post stock market break interval -- we have seen major gains in this regard. And, still other initiatives -- in both the public and private sector -- are under way.

However, in all of this, we are trying to hit a very rapidly moving target in a setting in which the risks of competition in laxity and regulatory arbitrage, nationally and internationally, are very real. To cite an illustration, if we take a fairly straightforward activity such as foreign exchange trading in New York and London there are at least five different regimes of capital and prudential standards that apply to that single activity depending on whether the firm in question is a bank, a merchant bank, an investment bank, a branch of one of the above, or a subsidiary of one of the above. Of course, if we put into the equation foreign exchange derivative products such as exchange traded futures and options as well as over the counter options, the matrix of regulatory regimes is probably increased by a factor of five.

That little example, Mr. Chairman, is reflective of the complex and technologically integrated financial world in which we live. And, it is also reflective of why I come before you with the sense of urgency I hope I have conveyed. Much is at stake, not only for our financial institutions and markets but for our national well-being more generally. The longer we fail to forge a coherent approach to these problems, the greater the danger that we will find ourselves scrambling for ad hoc solutions in a less hospitable environment than we face today.

Thank you.

STATISTICAL APPENDIX

To Accompany Statement by

E. Gerald Corrigan

before the Senate Banking Committee

July 13, 1989

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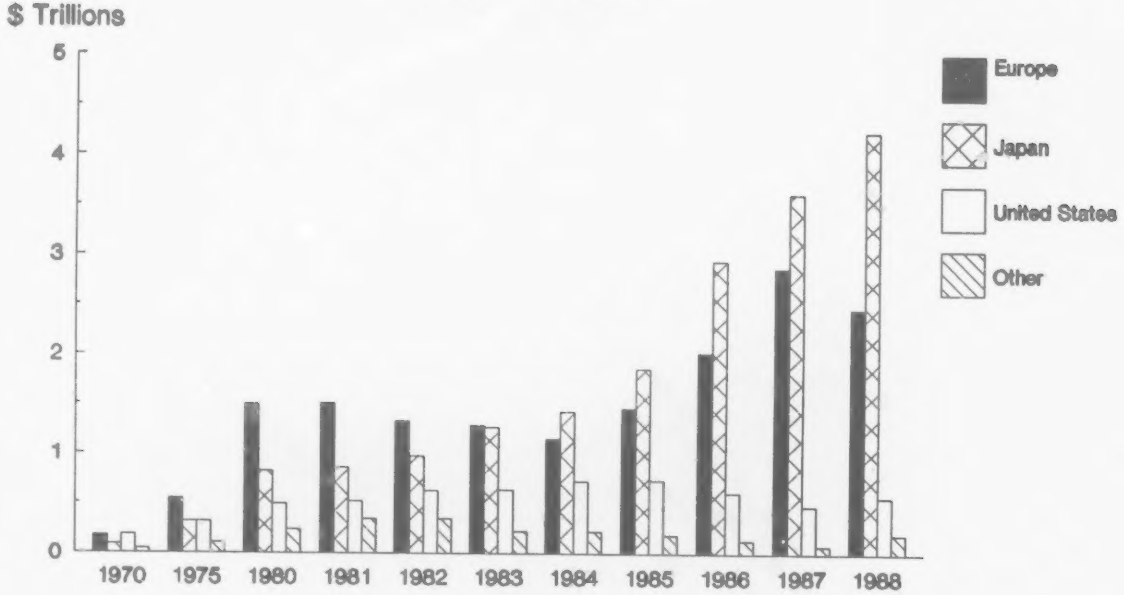
Aggregate Assets of World's 50 Largest Banks
by Country Group
1970 - 1988



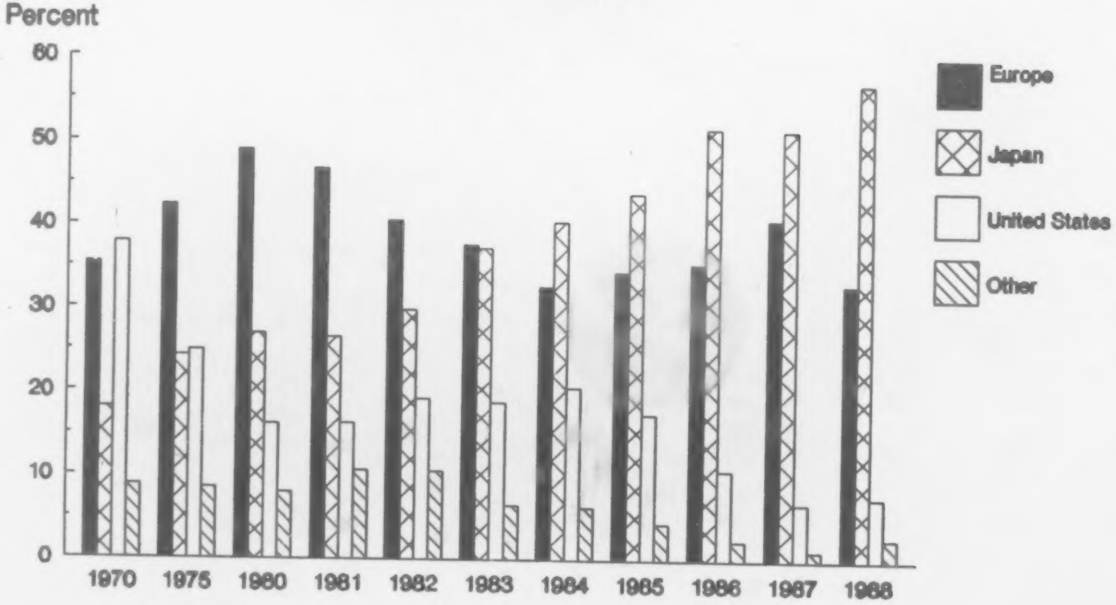
AGGREGATE ASSETS OF WORLD'S FIFTY LARGEST BANKS
BY COUNTRY GROUP
(Millions of dollars)

	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988
Europe	$176,188.6	$547,180.4	$1,495,655.1	$1,502,010.9	$1,326,263.5	$1,281,083.5	$1,150,635.6	$1,459,228.2	$2,014,312.3	$2,862,863.6	$2,454,780.2
Japan	89,837.3	314,266.4	824,432.3	854,687.7	975,950.6	1,266,591.4	1,423,575.1	1,858,367.4	2,931,330.7	3,608,095.2	4,229,391.4
United States	188,332.7	322,482.4	493,671.4	522,748.9	628,203.9	638,174.9	723,939.8	735,789.8	608,121.2	473,762.4	561,561.1
Other	43,620.6	109,358.6	241,686.1	341,785.5	342,545.4	219,695.5	221,851.8	186,033.7	134,330.2	77,625.1	195,540.8

Source: FORTUNE MAGAZINE, IBCA Banking Analysis, and INSTITUTIONAL INVESTOR.

Notes: 1. World' fifty largest banks by asset size.
2. Total asset figures for 1988 exclude contra-assets.
3. Group composition changes over time.

Asset Share of World's 50 Largest Banks
by Country Group
1970 - 1988



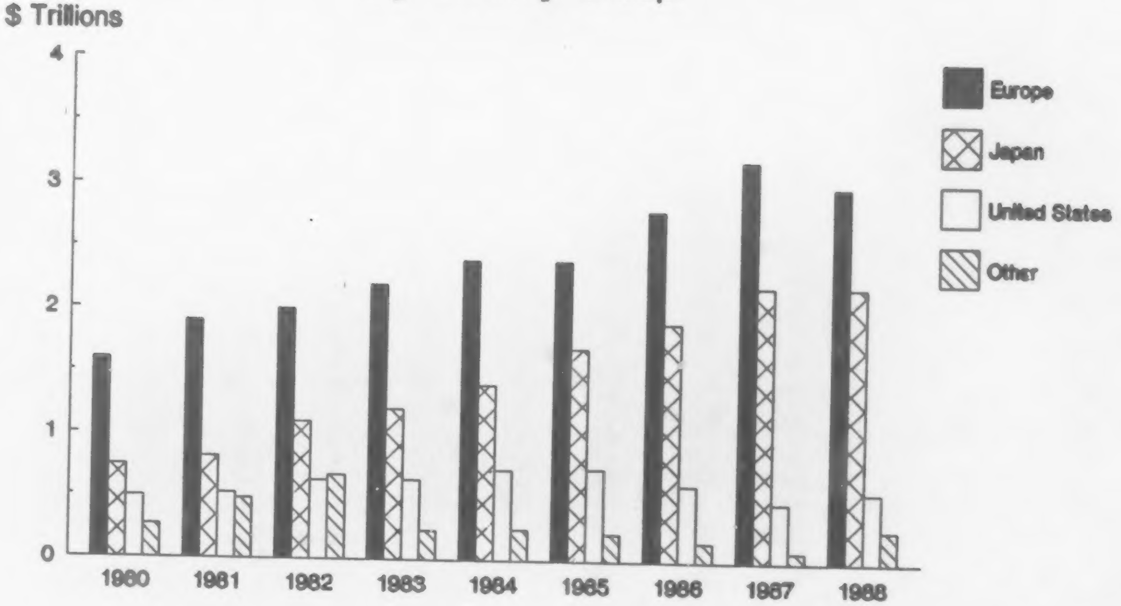
ASSET SHARE OF WORLD'S FIFTY LARGEST BANKS
BY COUNTRY GROUP
(Percent)

	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988
Europe	35.38%	42.31%	48.95%	46.63%	40.52%	37.62%	32.69%	34.42%	35.41%	40.77%	32.99%
Japan	18.04%	24.30%	26.98%	26.53%	29.82%	37.19%	40.44%	43.84%	51.53%	51.38%	56.84%
United States	37.82%	24.94%	16.16%	16.23%	19.19%	18.74%	20.57%	17.36%	10.69%	6.75%	7.55%
Other	8.76%	8.46%	7.91%	10.61%	10.47%	6.45%	6.30%	4.39%	2.36%	1.11%	2.63%
	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

Source: FORTUNE MAGAZINE, IBCA Banking Analysis, and INSTITUTIONAL INVESTOR.

Notes: 1. World's fifty largest banks by asset size.
2. Total asset figures for 1988 exclude contra-assets.
3. Group composition changes over time.

Asset Share of World's 50 Largest Banks Adjusted For Exchange Rate Changes By Country Group



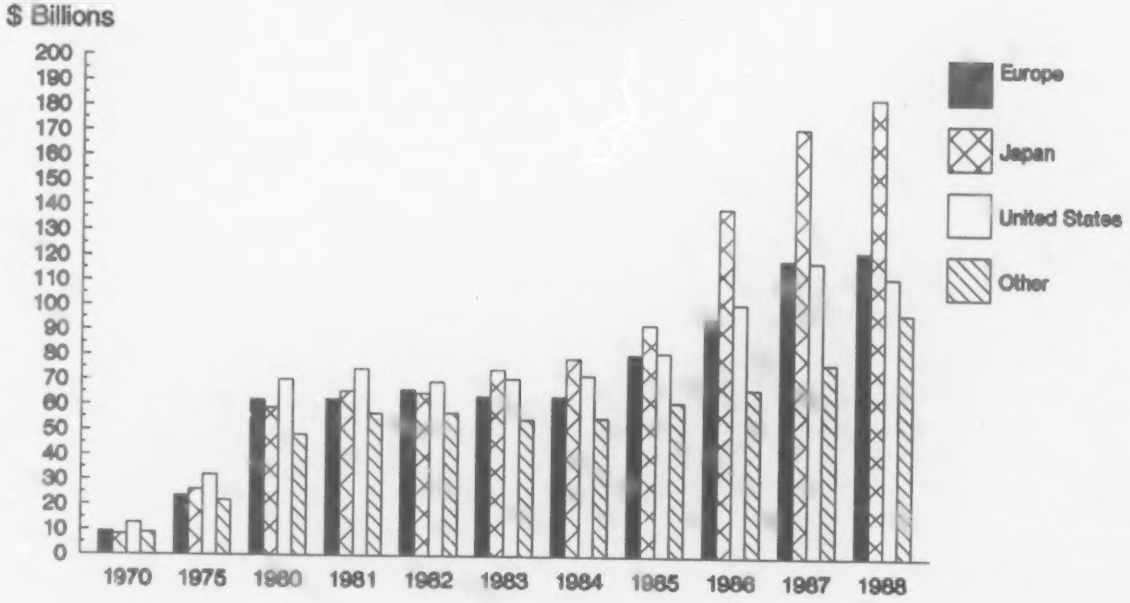
ASSET SHARE OF WORLD'S FIFTY LARGEST BANKS
ADJUSTED FOR EXCHANGE RATE CHANGES
BY COUNTRY GROUP
(Millions of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987	1988
Europe	1,637,113.5	1,949,340.9	1,986,487.0	2,218,628.7	2,399,134.0	2,398,406.1	2,811,984.9	3,229,776.1	2,995,947.9
Japan	738,689.9	815,510.4	1,080,055.2	1,245,467.9	1,438,649.0	1,711,582.9	1,906,008.5	2,207,384.6	2,203,682.1
United States	493,671.4	522,748.9	628,203.9	638,174.9	723,939.8	735,789.8	608,121.2	473,762.4	561,561.1
Other	269,754.4	482,656.7	673,395.7	230,877.1	247,525.4	217,242.2	159,271.2	87,071.0	264,355.9

Source of asset data: FORTUNE MAGAZINE, IBCA Banking Analysis, and INSTITUTIONAL INVESTOR.

Notes: 1. World's fifty largest banks by asset size.
2. Total asset figures for 1988 exclude contra-assets.
3. Group composition changes over time.
4. Asset figures are converted to U.S. dollars using December 31, 1979 exchange rates to adjust for large currency movements that occurred throughout the 1980s.

Average Assets of World's 50 Largest Banks
by Country Group
1970 - 1988



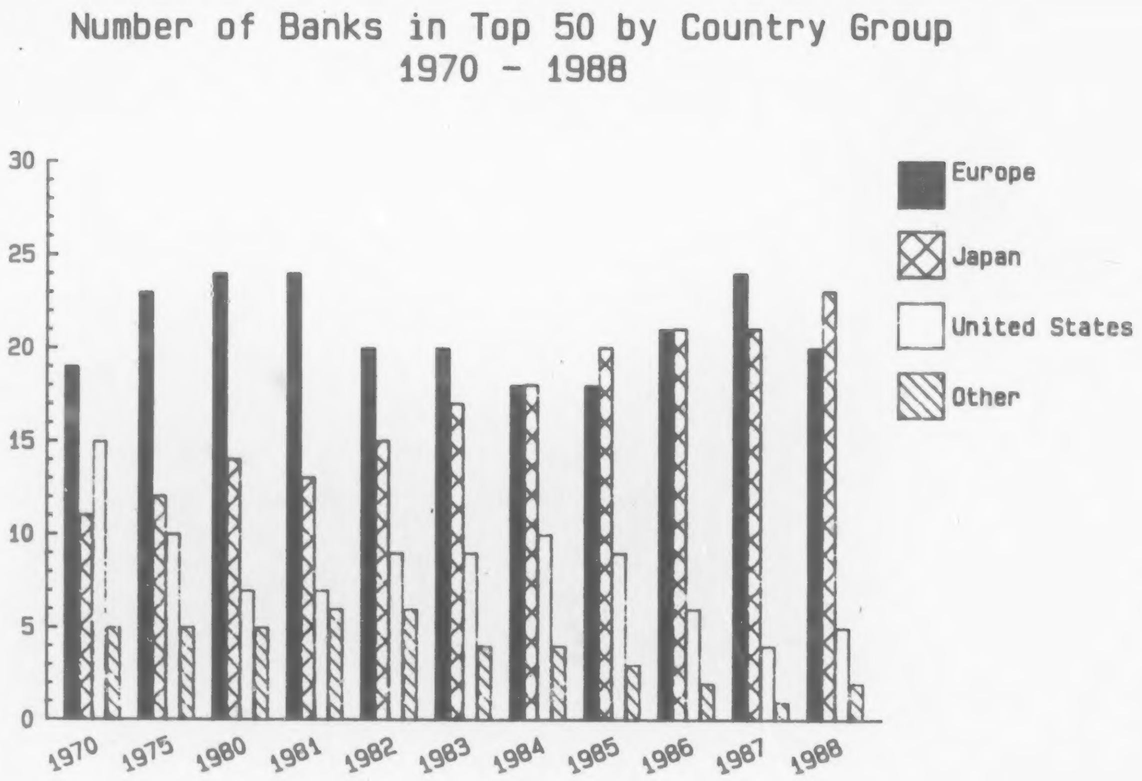
AVERAGE ASSETS OF WORLD'S
FIFTY LARGEST BANKS
BY COUNTRY GROUP

(Millions of dollars)

Country Group	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988
Europe	9,273	23,790	62,319	62,584	66,313	64,054	63,924	81,068	95,920	119,286	122,739
Japan	8,167	26,189	58,888	65,745	65,063	74,505	79,088	92,918	139,587	171,814	183,887
United States	12,556	32,248	70,524	74,678	69,800	70,908	72,394	81,754	101,354	118,441	112,312
Other	8,724	21,872	48,337	56,964	57,091	54,924	55,463	62,011	67,165	77,625	97,770

Source: FORTUNE MAGAZINE, IBCA Banking Analysis, and INSTITUTIONAL INVESTOR.

Note: World's fifty largest banks by asset size.



Number of Banks in Top 50 by Country Group
1970 - 1988

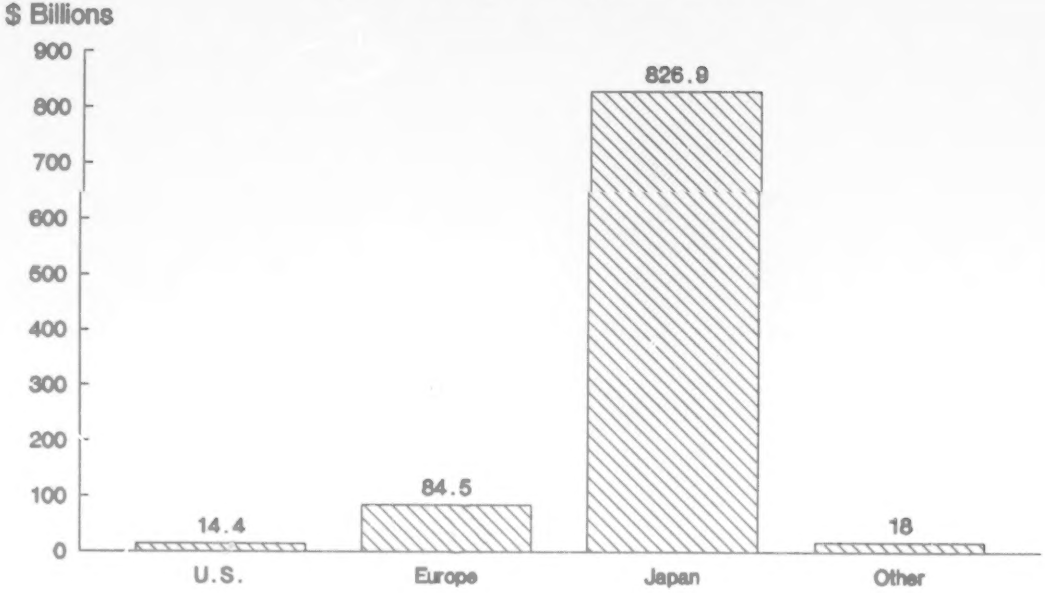
NUMBER OF BANKS IN TOP FIFTY
BY COUNTRY GROUP

Country Group	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988
Europe	19	23	24	24	20	20	18	18	21	24	20
Japan	11	12	14	13	15	17	18	20	21	21	23
United States	15	10	7	7	9	9	10	9	6	4	5
Other	5	5	5	6	6	4	4	3	2	1	2

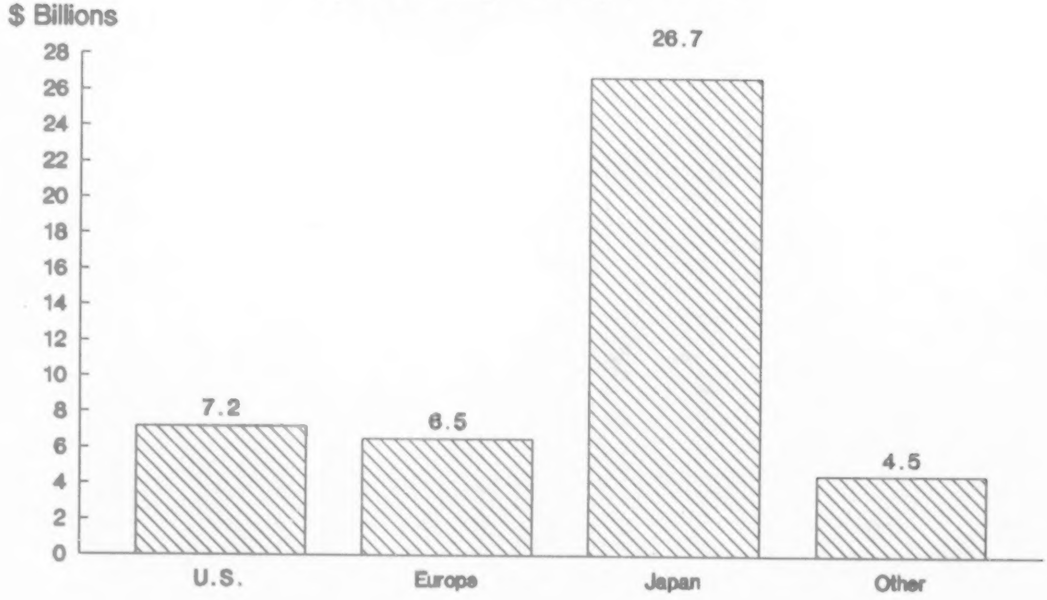
Source: FORTUNE MAGAZINE, IBCA Banking Analysis, and INSTITUTIONAL INVESTOR.

Note: World's fifty largest banks by asset size.

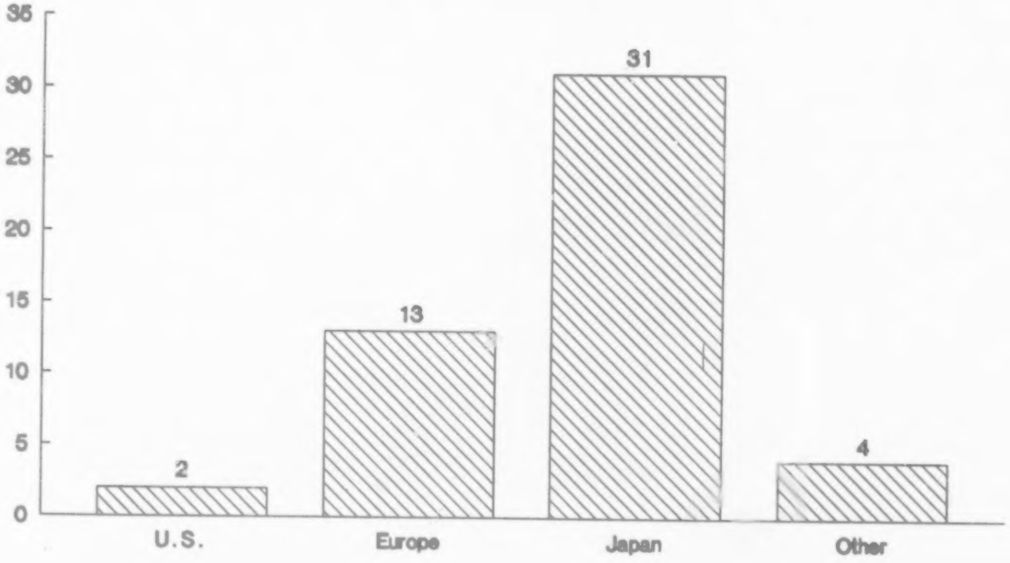
Total Market Capitalization
World's Top 50 Banks
By Country Group, 1988



Average Market Capitalization
World's Top 50 Banks
By Country Group, 1988



50 Largest Market Capitalizations
Number of Banks
By Country Group, 1988

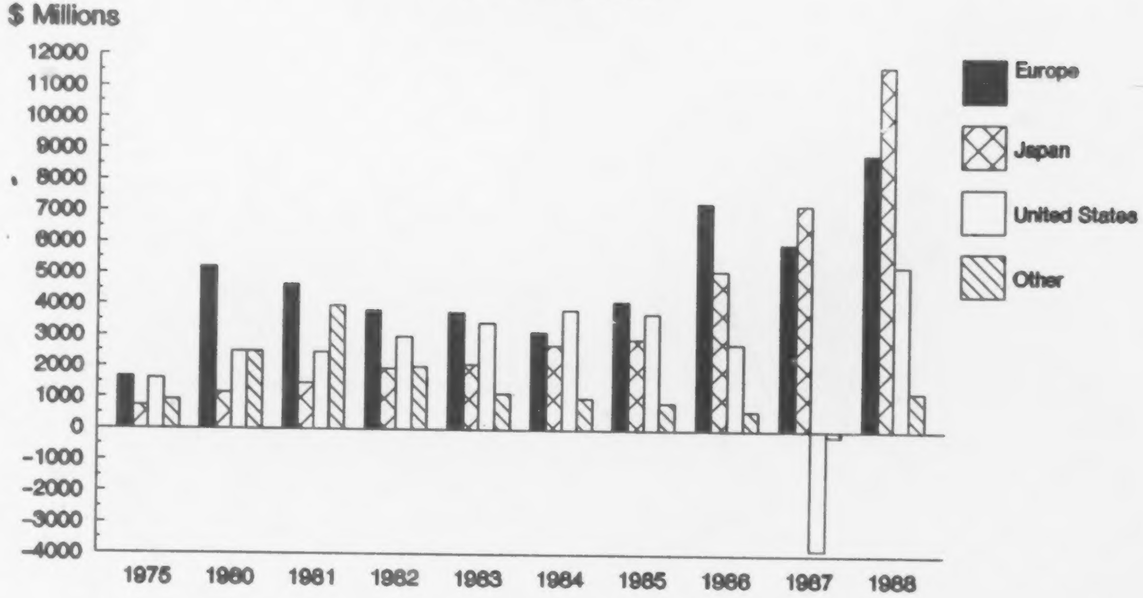


WORLD'S FIFTY LARGEST BANKS
(AS RANKED BY MARKET CAPITALIZATION)
BY COUNTRY GROUP, 1988

	Aggregate Market Capitalization (US $MM)	Average Market Capitalization (US $MM)	Number of Banks Among World's Fifty Largest
United States	$14,435	$7,217.5	2
Europe	84,515	6,501.2	13
Japan	826,885	26,673.7	31
Other	17,922	4,480.5	4

Source: EUROMONEY MAGAZINE.

Aggregate Net Income of World's 50 Largest Banks
by Country Group
1975 - 1988



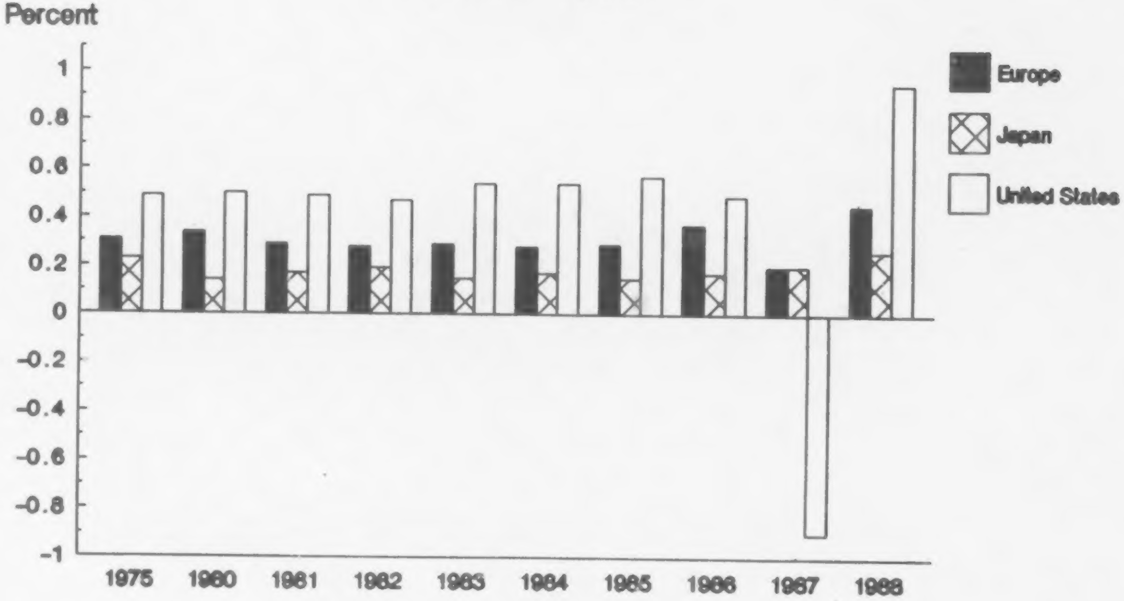
AGGREGATE NET INCOME OF WORLD'S FIFTY LARGEST BANKS
BY COUNTRY GROUP
(Millions of dollars)

	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988
Europe	1,661.0	5,202.4	4,632.5	3,820.6	3,752.7	3,125.9	4,110.8	7,280.1	5,978.0	8,867.8
Japan	710.0	1,152.9	1,452.7	1,938.5	2,083.9	2,690.7	2,905.2	5,111.5	7,238.1	11,664.8
United States	1,608.7	2,466.2	2,458.1	2,949.8	3,402.6	3,832.8	3,735.8	2,761.0	(3,841.5)	5,283.6
Other	914.2	2,463.9	3,951.1	1,998.5	1,157.7	1,004.1	877.4	605.6	(193.3)	1,225.7

Source: FORTUNE MAGAZINE, IBCA Banking Analysis, and INSTITUTIONAL INVESTOR.

Notes: 1. World's fifty largest banks by asset size.
2. 1988 net income figures are not available for four European banks.
3. Group composition changes over time.

Average ROA of World's 50 Largest Banks
by Country Group
1975 - 1988



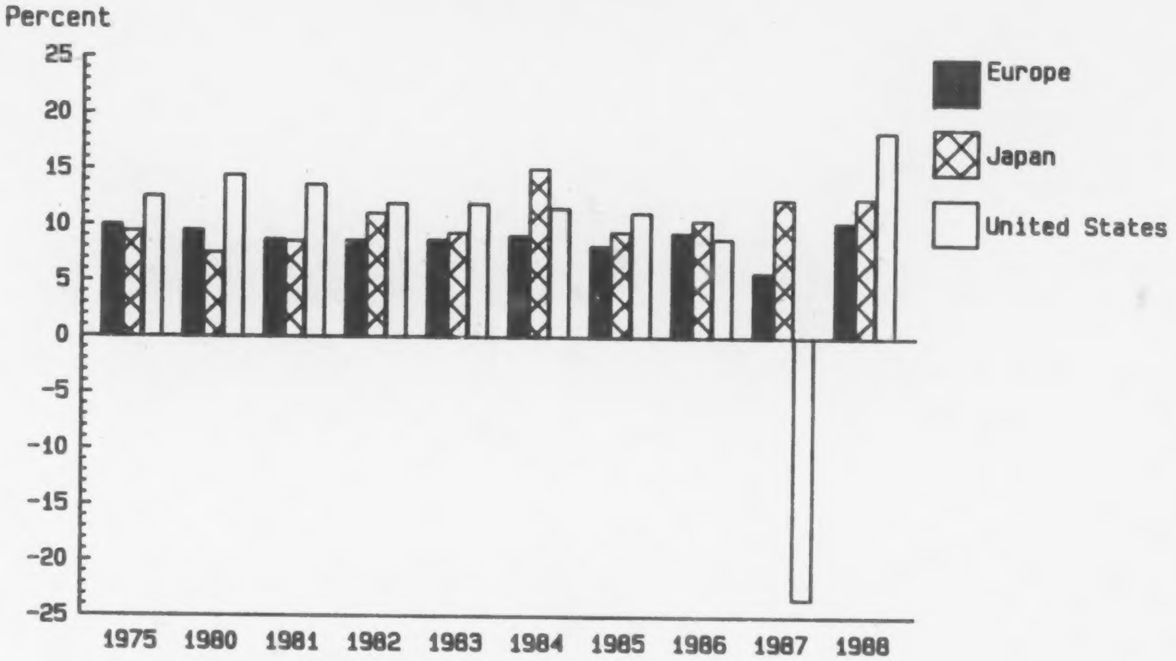
AVERAGE RETURN ON ASSETS OF WORLD'S FIFTY LARGEST BANKS
BY COUNTRY GROUP
(Percent)

	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988
Europe	0.31%	0.34%	0.29%	0.28%	0.29%	0.28%	0.29%	0.37%	0.20%	0.45%
Japan	0.23%	0.14%	0.17%	0.19%	0.15%	0.17%	0.15%	0.17%	0.20%	0.26%
United States	0.49%	0.50%	0.49%	0.47%	0.54%	0.54%	0.57%	0.49%	-0.90%	0.95%
Other	0.73%	0.97%	1.06%	0.58%	0.53%	0.45%	0.47%	0.45%	-0.25%	0.64%

Source of asset and income data: FORTUNE MAGAZINE, IBCA Banking Analysis, and INSTITUTIONAL INVESTOR.

Notes: 1. World's fifty largest banks by asset size.
2. 1988 net income figures are not available for four European banks.
3. Group composition changes over time.

Average ROE of World's 50 Largest Banks
by Country Group
1975 - 1988



AVERAGE RETURN ON EQUITY OF WORLD'S FIFTY LARGEST BANKS
BY COUNTRY GROUP
(Percent)

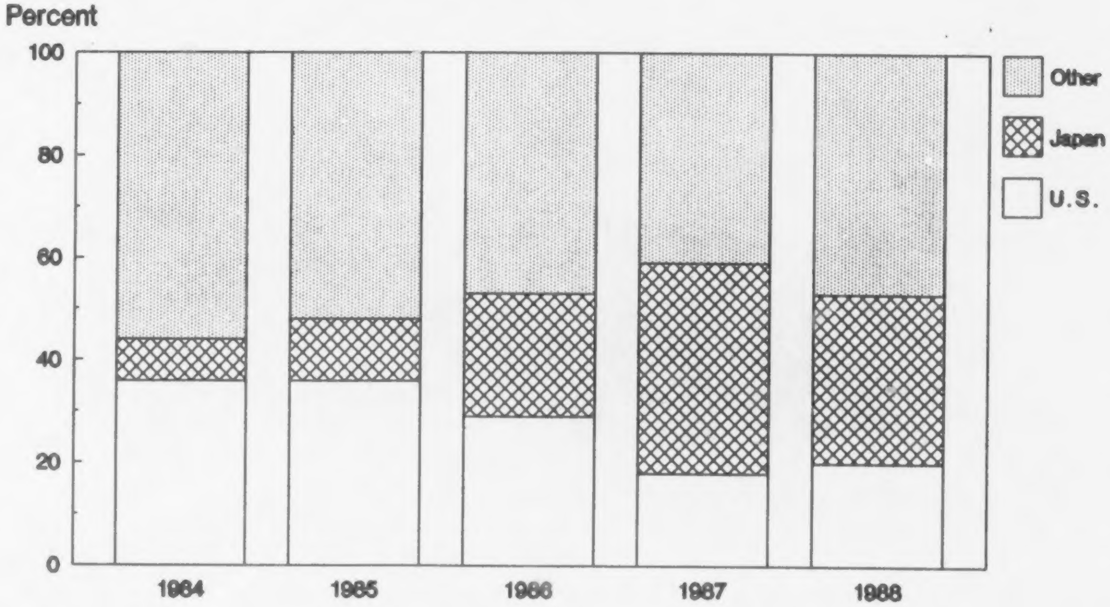
	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988
Europe	10.03%	9.53%	8.70%	8.64%	8.71%	9.09%	8.19%	9.37%	5.81%	10.30%
Japan	9.45%	7.54%	8.57%	11.06%	9.34%	15.05%	9.45%	10.46%	12.35%	12.47%
United States	12.55%	14.45%	13.61%	11.94%	11.93%	11.54%	11.14%	8.83%	-23.47%	18.38%
Other	17.20%	20.35%	22.41%	13.65%	14.54%	11.10%	10.87%	10.09%	-5.83%	13.04%

Source of equity and income data: FORTUNE MAGAZINE, IBCA Banking Analysis, and INSTITUTIONAL INVESTOR.

Notes: 1. World's fifty largest banks by asset size.
2. 1988 net income figures are not available for four European banks.
3. Group composition changes over time.

SHARE OF THE TOP 50 EUROBOND BOOK RUNNERS*

BY NATIONALITY



* Primary lead managers

Source: International Financing Review

TOP 50 EUROBOND BOOKRUNNERS BY NATIONALITY
(US$ Billions)

	1988		1987		1986		1985		1984	
	TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*
US	32.7	20%	23.7	18%	49.9	29%	46.1	36%	27.9	36%
UK	15.6	9%	13.7	10%	12.9	7%	13.4	10%	7.1	9%
SWISS	22.2	13%	15.1	11%	27.3	16%	24.9	19%	15.1	20%
JAPAN	54.0	33%	53.9	41%	42.1	24%	15.8	12%	6.4	8%
WGERMAN	24.7	15%	15.7	12%	20.3	12%	11.3	9%	9.1	12%
FRANCE	10.4	6%	7.6	6%	15.5	9%	10.2	8%	6.1	8%
OTHER	8.6	5%	5.8	4%	8.8	5%	6.4	5%	5.5	7%
TOTAL OF TOP 50	168.3		135.7		176.9		128.1		77.2	
TOTAL MARKET	172.5		141.9		183.9		133.1		79.8	
TOP 50 AS % OF TOTAL MARKET	98%		96%		96%		96%		97%	

* Share of the top 50
Source: International Financing Review

VOLUME OF EURO-BOND ISSUANCE
BY NATIONALITY OF THE TOP 50 BOOKRUNNERS

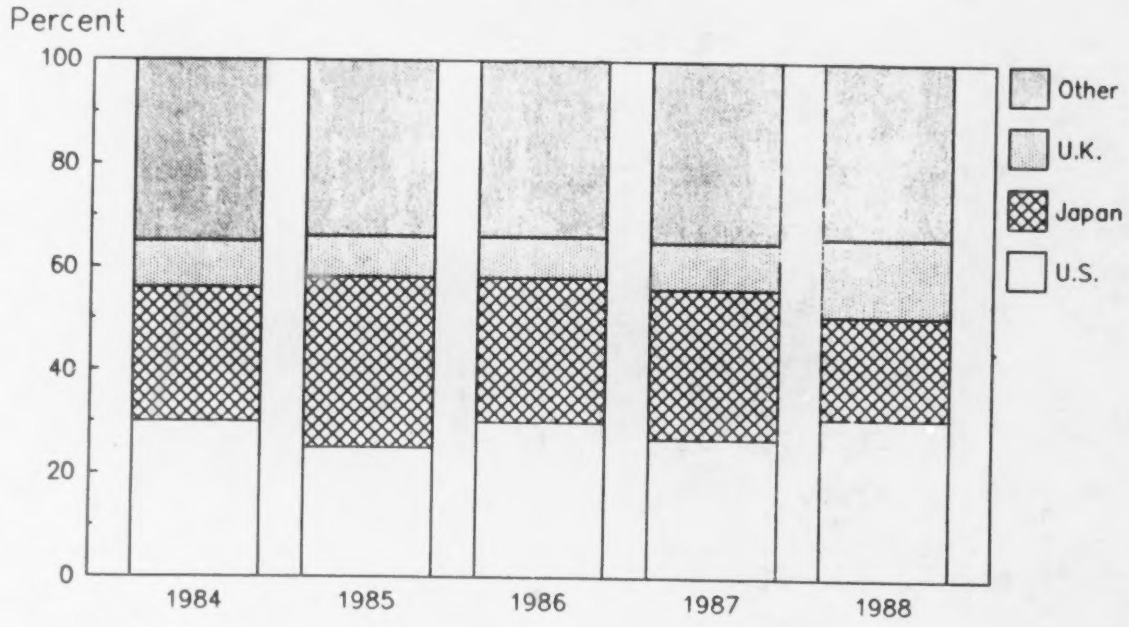
		1988		1987		1986		1985		1984	
		TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*
US	BANK	12.8	7%	8.3	6%	17.1	9%	15.2	11%	9.3	12%
	SEC.	20.0	12%	15.4	11%	32.8	18%	30.9	23%	18.6	23%
UK	BANK	11.1	6%	9.8	7%	10.2	6%	10.9	8%	5.1	6%
	SEC.	4.5	3%	4.0	3%	2.7	1%	2.6	2%	1.9	2%
SWISS	BANK	8.3	5%	5.6	4%	7.7	4%	6.3	5%	1.8	2%
	SEC.**	13.9	8%	9.5	7%	19.6	11%	18.6	14%	13.3	17%
JAPAN	BANK	4.8	3%	6.9	5%	5.6	3%	1.7	1%	0.0	0%
	SEC.	49.2	29%	47.0	33%	36.5	20%	14.1	11%	6.4	8%
WGERMAN	BANK	24.7	14%	15.7	11%	20.3	11%	11.3	8%	9.1	11%
	SEC.	0.0	0%	0.0	0%	0.0	0%	0.0	0%	0.0	0%
FRANCE	BANK	10.4	6%	7.6	5%	15.5	8%	10.2	8%	6.1	8%
	SEC	0.0	0%	0.0	0%	0.0	0%	0.0	0%	0.0	0%
OTHER	BANK	5.6	3%	4.5	3%	7.1	4%	5.7	4%	4.6	6%
	SEC.	3.0	2%	1.3	1%	1.7	1%	0.7	0%	0.9	1%
TOTAL	BANK	77.6	45%	58.5	41%	83.5	45%	61.3	46%	36.0	45%
	SEC.	90.6	53%	77.2	54%	93.4	51%	66.8	50%	41.1	52%

BANK = Commercial and Merchant Banks, or their affiliates
SEC. = Securities Firms

* Share of total bond issuance
** Includes only CSFB. All other Swiss sec. firms are bank affiliates.
Source: International Financing Review

SHARE OF TOP 50 LEAD MANAGERS OF EUROLOANS

BY NATIONALITY



Source: International Financing Review

TOP 50 LEAD MANAGERS OF EURO-SYNDICATED LOANS BY NATIONALITY
(US$ Billions)

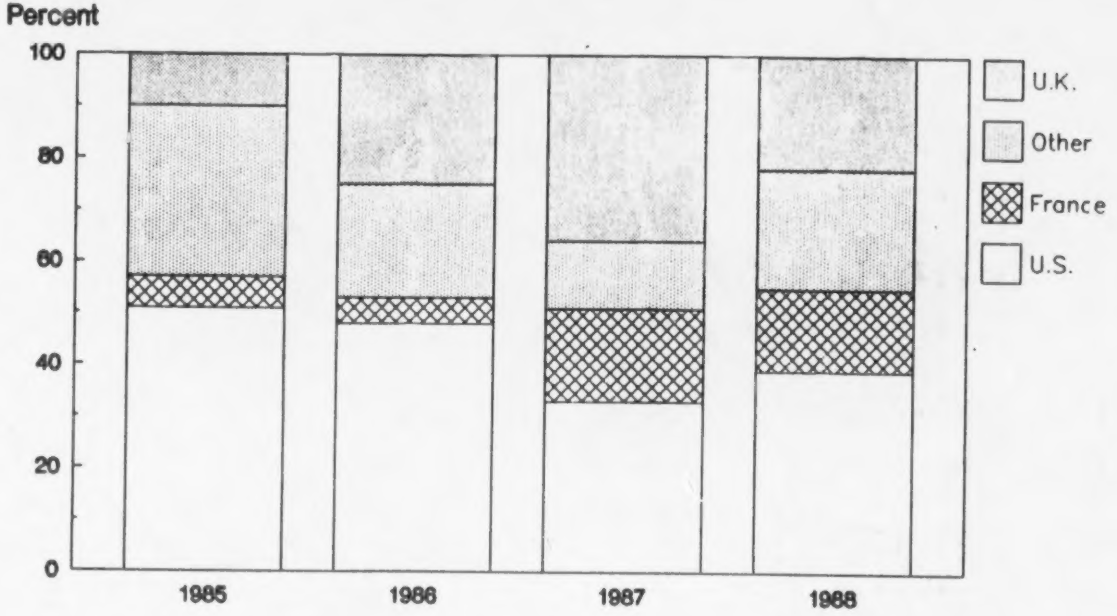
	1988		1987		1986		1985		1984	
	TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*
US	350.1	31%	331.2	27%	237.0	30%	159.9	25%	264.1	30%
UK	166.9	15%	114.0	9%	64.0	8%	48.9	8%	75.0	9%
SWISS	79.4	7%	59.0	5%	36.2	5%	8.8	1%	13.1	2%
JAPAN	228.8	20%	358.1	29%	225.0	28%	206.0	33%	228.5	26%
WGERMAN	80.0	7%	90.8	7%	53.5	7%	32.2	5%	37.4	4%
FRANC.	91.0	8%	93.0	8%	80.0	10%	80.9	13%	83.7	10%
OTHER	125.3	11%	192.3	16%	99.2	12%	90.6	14%	176.4	20%

* Share of the top 50

Source: International Financing Review

SHARE OF TOP 50 NOTE ISSUANCE FACILITY ARRANGERS

BY NATIONALITY



Source: International Financing Review

TOP 50 ARRANGERS OF NEW NOTE ISSUANCE FACILITIES BY NATIONALITY
(US$ Billions)

	1988		1987		1986		1985	
	TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*
US	10.2	39%	23.7	33%	25.6	48%	50.4	51%
UK	5.8	22%	26.3	36%	13.5	25%	10.3	10%
SWISS	0.4	1%	3.6	5%	1.4	3%	10.7	11%
JAPAN	0.2	1%	1.0	1%	5.1	10%	3.8	4%
WGERMANY	0.1	1%	0.0	0%	0.2	0%	1.0	1%
FRANCE	4.3	16%	12.7	18%	2.5	5%	5.7	6%
OTHER	5.3	20%	5.0	7%	5.3	10%	16.7	17%

* Share of top 50

Source: International Financing Review

TOP 25 ARRANGERS OF NEW EURO-COMMERCIAL PAPER AND EURO-CD PROGRAMS BY NATIONALITY
(Number of deals)

	1988		1987		1986		1985	
	TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*	TOTAL	SHARE*
US	319	51%	410	61%	397	65%	102	58%
UK	77	12%	87	13%	74	12%	18	10%
SWISS	123	20%	126	19%	118	19%	45	25%
JAPAN	65	10%	8	1%	8	1%	0	0%
WGERMAN	0	0%	0	0%	5	1%	0	0%
FRANCE	0	0%	0	0%	0	0%	5	3%
OTHER	42	7%	40	6%	8	1%	7	4%

* Share of the top 25

Source: International Financing Review

N.B.: The US$ value of deals by nationality is not available.

TOP 10 ARRANGERS OF EURO-MEDIUM TERM NOTE PROGRAMS BY NATIONALITY
(Number of deals)

	1988		1986/87*	
	TOTAL	SHARE**	TOTAL	SHARE**
US	54	64%	54	58%
UK	10	12%	16	17%
SWISS	20	24%	23	25%

* Data for 1986 alone was not available. OECD statistics show $1.7 billion of programs arranged in 1986 as compared to $8 billion in 1987.

** Share of the top 10

N.B.: The US$ value of deals by nationality is not available.

INTERNATIONAL BONDS*
NATIONALITY OF LEAD MANAGERS BY CURRENCY, 1988
Source: Bank of England, Intl. Division

AMOUNT USDOLLAR BNS

	LEAD MANAGERS (NATIONALITY)						
	U.S.	U.K.	WEST GERMANY	JAPAN	SWISS	OTHER	TOTAL
US$	28.3	1.0	1.5	39.3	9.2	3.7	83.1
GBP	6.6	11.7		0.2	5.6		24.0
DM	1.4	0.7	19.7	0.5	1.1	0.2	23.6
YEN	1.6	0.2		18.7	0.1	0.0	20.6
SWF	1.3	1.8	0.2	0.3	20.3	2.8	26.6
ECU	1.8		1.8	0.9	2.3	4.2	11.1
OTHER	6.6	2.3	3.3	1.3	3.7	20.0	37.2
TOTAL	47.5	17.6	26.6	61.2	42.3	31.0	226.2

INTERNATIONAL BONDS*
NATIONALITY OF LEAD MANAGERS BY CURRENCY, 1988 (PERCENT)
Source: Bank of England, Intl. Division

AMOUNT USDOLLAR MNS

	LEAD MANAGERS (NATIONALITY)						
	U.S.	U.K.	WEST GERMANY	JAPAN	SWISS	OTHER	TOTAL
US$	34%	1%	2%	47%	11%	4%	100%
GBP	28%	49%	0%	1%	23%	0%	100%
DM	6%	3%	84%	2%	5%	1%	100%
YEN	8%	1%	0%	91%	1%	0%	100%
SWF	5%	7%	1%	1%	76%	10%	100%
ECU	16%	0%	16%	8%	21%	38%	100%
OTHER	18%	6%	9%	3%	10%	54%	100%

* Includes both Eurobonds and foreign bonds (e.g. Yankee bonds).

REMARKS BEFORE THE
61ST ANNUAL MID-WINTER MEETING OF THE
NEW YORK STATE BANKERS ASSOCIATION
THURSDAY, JANUARY 26, 1989

BY E. GERALD CORRIGAN, PRESIDENT
FEDERAL RESERVE BANK OF NEW YORK

Good afternoon ladies and gentlemen; it is a pleasure to appear again before the mid-winter meeting of the New York State Bankers Association. Many of you will recall that two years ago, before this same audience, I unveiled my essay on the evolving financial structure in the United States -- Financial Market Structure: A Longer View.

Today I want to take inventory of developments since then to see how much has been achieved in the effort to move toward a more coherent, a more fairly competitive and a safer banking and financial system -- a goal that I continue to regard as being of utmost importance.

Needless to say, any such assessment must take account of developments not just here in the United States, but abroad as well. Regrettably, my conclusion is that while there are some positives, we are no closer today to that goal than we were two years ago. Indeed, in relation to developments in other major countries a strong case can be made that we have actually lost ground.

For understandable reasons, much of the public attention my essay received focused on the framework or the model I proposed as to what the future banking and financial structure in the United States might look like. In a way, that was unfortunate because the details of any particular structure -- including the one I suggested -- are not as important as the broad policy framework on which it is based. In any case, partly for that reason attention was diverted from two broader facets of the essay which, to my way of thinking, were at least as important as the suggested structure itself. Those two facets were: first, the analysis of the market, institutional and technological forces which, in my judgment, were rendering the current financial structure increasingly outmoded and increasingly at odds with developments in the global banking and financial system. If anything, the trends and forces I cited then have become more powerful and it is partly for this reason that I believe the case for basic reform is more compelling today than it was two years ago. Indeed today, as two years ago, the strength and irreversibility of those forces is also a reason why I regard the process of muddling our way through this period of unprecedented change as not only short-sighted but also potentially dangerous to the health and well-being of the system.

The second facet of the essay which got lost in the dust and to which I attach great importance, relates to the implications of changing financial practices for the integrity and workings of the so-called safety net -- including the workings of the supervisory process.

Against that background, let me try to summarize and catalog some of the more important developments of the past two years which relate to the evolution -- or the lack thereof -- of our banking structure. For purposes of presentation, I shall place these developments into three major categories: those that are, on balance, positive; those that have mixed or unclear implications and, finally, those that I view as having distinctly adverse implications. On the positive side I would cite the following:

First, overall economic activity, especially in the industrial world, has held up remarkably well and has thereby provided both the time and the environment within which the massive changes we are seeing on the financial side can be absorbed more easily. While this is a plus in one sense, it is also a lost opportunity in that the longer we fail to achieve basic reform the greater the risks the ultimate transition will occur in a less hospitable economic environment than we have been experiencing.

Second, I am encouraged by the continued substantial strengthening of bank capital and reserves over the past several years. By any standard and by any measure, the build-up in capital resources, especially of the money center banks, has been dramatic, but also much needed. A related and also distinctly positive development was the emergence of the B.I.S. international capital standards. This approach to international harmonization of bank capital standards -- in spite of its obvious limitations -- represents a giant step forward in efforts to better rationalize both competitive and prudential considerations among nations while at the same time providing important elements of breathing room for national authorities to permit national systems to grow and evolve in line with national priorities.

While the progress that has been made in building capital is truly impressive, it does not, in my view, warrant any sense of complacency that the job is done. To the contrary, for many institutions measures of asset quality, while improving somewhat, are still troublesome given where we are in the business cycle. Moreover, assessments of capital adequacy must also and increasingly take account of new and different forms of both credit and market risk. And, on the international side, the LDC debt situation -- despite the enormous reductions in relative LDC exposure at all banks -- still constitutes a significant source of potential vulnerability for the banking system here and abroad.

Third, another generally positive development over the past two years has been the gains made in providing greater product and geographic diversity for banks and bank holding companies. For example, taking account of laws now on the books, generalized inter-state banking will -- for all practical purposes -- be a reality by the early 1990s. Similarly, through the vehicle of the so-called Section 20 subsidiaries, the Federal Reserve has permitted bank holding companies to engage in a broadened range of securities

activities.

While these developments should be welcomed, we must also recognize that much of what has been gained in these areas has come about in something of a crazy-quilt pattern of initiatives by the states, the courts and the bank regulators. As such, these gains -- especially in the area of product diversification -- could be reversed by the Congress or could be watered down by regulatory restraints that diminish their going concern value to individual institutions, especially from the viewpoint of international competitiveness. Hopefully, as experience is gained and with the passage of time, some of the regulatory baggage associated with the Section 20 subsidiaries can be lifted, thereby bringing such arrangements into closer alignment with patterns we see in the marketplace here and abroad.

Fourth, another distinctly positive development has been the increased attention and efforts in both the public and private sector to better understand, to contain and ultimately to reduce risks in large scale payments and settlement systems. Here, while much remains to be done, much has already been achieved in a context in which the events of October 1987 should have removed any lingering doubts as to the extent to which failure or disruption in these payment and settlement systems can be a source of potentially serious and systemic dangers not merely to the banking system but to the financial system at large. Moreover, even with all of the gains that have been made, competitive, market and technological pressures are pushing clearing and settlement systems to new frontiers of complexity and potential risk. For example, 24-hour world-wide trading in an increasingly wide array of financial and derivative financial instruments is further magnifying the operational, liquidity and credit interdependencies in many such systems.

These are developments which, on balance, have been working in a constructive direction, even though in each case there is much in the way of unfinished business. Let me now

turn to another class of developments which I view as distinctly more mixed in their implications for U.S. financial markets and institutions:

First: in the major industrialized countries outside the United States great progress is being made in the direction of comprehensive restructuring of banking and financial systems in a setting in which the emerging common denominator is common ownership of a wide range of banking and financial institutions. In a number of European countries, that pattern was already present in the form of the universal bank. More recently, in countries such as Canada, the U.K., and France we are seeing sweeping reforms in financial market structure. In addition, it now appears virtually certain that the 1992 changes in the European Community will provide major new momentum to these forces both in regard to geographic and product expansion. Specifically, it appears that any bank licensed to do business in any one European Community country will be able to branch into all others and will be able to offer a full range of banking, securities and possibly even insurance activities -- even if some of those activities are not presently permitted for domestic banks in the host country in question.

Since the broad thrust of these changes are in the direction of more open and more competitive banking and financial systems, you may wonder why I classify them as mixed in their implications. There are two reasons for this: first, as restructuring proceeds abroad, the U.S. structure and U.S. institutions are increasingly the odd man out. There are obviously important implications arising from this for the potential competitiveness of U.S. financial markets and institutions.

My second concern relates to the danger that, as restructuring abroad proceeds, international frictions could intensify insofar as the rights and privileges of financial institutions to operate in foreign markets are concerned. Even now, there are those in Europe who would argue that the E.C. should follow some formulation of a

policy of reciprocity which, at the extreme, could be quite detrimental to the interests of U.S. banking and financial firms. In such a setting, we could easily find ourselves on the dangerously slippery slope of protectionism in the arena of banking and finance -- a result that clearly is in no one's best interest. That is one reason why we must continue to push for broad based international acceptance of the principle of national treatment; even more importantly, it is also why we in the U.S. must push ahead with efforts to reform our own banking and financial systems so as to reduce or eliminate unnecessary points of structural stress and conflict.

The second set of forces I will cite in the mixed category is the continuing pell-mell pace of financial innovation both domestically and internationally. New and complex instruments and trading strategies continue to proliferate and their use becomes more pervasive; securitization, rather than slowing, has accelerated with lower credit quality participants now a more prominent part of the process; and, banking and other financial institutions are becoming progressively more dependent on trading gains, loan syndication fees, and related sources of income and profit which may not be sustainable over time or over the business cycle.

I place these factors in the mixed category not because the process of innovation and structural change is inherently troublesome. To the contrary, these may be distinctly positive forces over time. The problem is that in the shorter-run they almost inevitably involve transitional difficulties and some painful lessons being learned the hard way.

Clearly, we have seen evidence of this; for some, Big Bang in London was more like big bust, as institutional overcrowding -- among other things -- took its toll; here in the New York market, similar forces have put operating margins for a wide variety of firms under pressure as the combination of expense growth together with shortfalls in ticket writing have forced some difficult

adjustments by individual firms.

But, nowhere was the mixed blessing of innovation more apparent than it was when equity markets collapsed in October 1987. At that time we saw vivid illustrations of (1) the inherent imperfections of seemingly "safe" hedging strategies; (2) the premise of market liquidity proving to be an illusion of liquidity; and (3) the enormous complexities of a potentially systemic nature that can arise in a setting in which markets and institutions are so closely intertwined domestically and internationally.

Fortunately, our experiences to date have been reassuring in that the system as a whole has withstood these potentially serious problems remarkably well. But, the fact that these troubled waters have been navigated without major and lasting damage to the system should not give rise to a false sense of security. While we have learned much from these experiences, we surely can not afford to relax our guard, especially as change and innovation proceeds apace.

A third and distinctly mixed development has been the potentially serious economic and financial consequences of the substantial increase in leverage in corporate America. I view this development as mixed -- as opposed to outright negative -- only because some of what we are seeing in this area may be playing a constructive role in the much needed re-vitalization of the U.S. economy.

Yet, it remains to be seen if the financial engineering that is being devoted to these activities can produce the electrical and mechanical engineering -- to say nothing of the hard investment -- that is needed to make the U.S. truly competitive for the 1990s and beyond. So, however beneficial corporate restructurings may be in individual cases or in the short run, the fact remains that in the aggregate we have witnessed an enormous reduction in the equity cushion in large segments of the non-financial business sector of the U.S. economy. This process inevitably and appropriately raises questions as to how

these highly leveraged firms and their creditors and shareholders will fare in a less favorable economic and financial setting with even more intensive international competition.

Moreover, the complexities and innovations in many of these transactions call for a very high degree of due diligence on the part of all participants to the financing in a setting in which a single financial institution may have multifacted relationships with a firm particularly in the context of corporate restructuring transactions. Moreover, the success of individual transactions depends not only on future overall economic prospects but also on a liquid and well functioning market for high yielding securities and a strong market for the disposition of assets needed to generate cash flow to service and reduce debt.

These developments which I have characterized as mixed in their implications also have a common denominator and that is it will only be with the passage of time that we will have a full appreciation of their ultimate consequences. Clearly each of them can, in time, prove beneficial but on the other hand they can also be the source of new problems and at the very least they can pose some transitional difficulties.

At the other end of the scale, however, the past two years have also witnessed some distinctly negative developments in the financial arena that are relevant to efforts to better rationalize our banking and financial system. Among those negatives are the following:

First, legislative gridlock remains. Indeed, while the moratorium has come and gone and while the Senate passed the progressive and forward looking Proxmire-Garn bill by an overwhelming majority last year, complementary action by the House did not materialize. Thus, the process of legislative reform remains stalled and the prospects for early action in the new Congress look dim. In these circumstances, muddling through continues and with it the risk that we will arrive at a de facto solution which, whether we like it or not, or whether it best serves the public interest or not, will be very difficult to alter except in the context of instability.

Second, we are seeing further erosion in the separation between banking and commerce in

part because of developments in the thrift industry but also because through LBOs and related transactions, financial institutions are taking progressively larger equity stakes in commercial firms. I may be a bit old-fashioned, but I still view with concern if not alarm the consequences of drifting into a situation in which we are prepared to permit the co-mingling of commercial and banking institutions. Moreover, I am a bit uneasy about the growing tendency of investment banks to be sizeable equity holders in firms for which they render a wide variety of investment banking services.

I don't intend to repeat the reasons for my concern about the merging of banking and commerce in any detail at this time. But, I will say that the adverse consequences of such arrangements for (1) the impartiality of the credit decision making process; (2) potential elements of concentration and unfair competition; and (3) the de facto extension of the safety net, are such that I will continue to strongly resist the ownership and control of banking institutions by commercial concerns absent a compelling public policy reason for such combinations -- a compelling reason which I still do not see at this time.

I recognize that developments in the thrift industry are working against this position. Here, I would simply repeat my earlier view that if there are no other options, then thrifts owned by commercial firms should be confined to a narrow line of business that focuses heavily on residential mortgage lending and limits the scope for tie-ins with other business entities. Indeed, I believe that there is at least a question as to whether some part of the acute problems we are seeing in the thrift industry may not reflect existing patterns of ownership for some of the seriously troubled institutions.

The debate about the separation of banking and commerce also has its international dimension. For one thing, in the industrial countries it is uncommon to find banks -- especially major banks -- owned and controlled by commercial firms.

Yet there are countries in which banks have considerably more flexibility in the extent to which they may have equity interests in commercial firms. Still further, in countries such as Japan, and to a lesser degree Italy and Canada, which have had reasonably contemporary experiences with the blending of banking and commerce, the tendency is to seek to reduce the extent of such co-mingling. Finally, in the U.K., where there is no formal prohibition against a commercial firm owning a bank, the authorities have made it quite clear that any effort by a commercial concern to acquire control of a major bank would, at the very least, receive very considerable scrutiny.

It is not easy to see how this debate will be resolved domestically or internationally, but I for one cling to the hope that we have the vision and the will to insist on a solution that is well thought out and is designed to serve the best long-run interests of the public at large.

A *third* distinctly negative development over the past year has been the abuse of the deposit insurance system. For obvious reasons, I don't want to offer my own suggestions about possible solutions to the thrift crisis or to the larger question of possible reform of the deposit insurance system, but I do want to make several general points. *First*, in my view the solution to the thrift crisis should be comprehensive and get at not just its symptoms but at its underlying causes. *Second*, the deposit insurance funds should not be merged, at least until the financial and structural solution to the thrift problem is in hand. *Third*, while some reform of the deposit insurance system seems necessary that task must be approached with great care. For example, risk-based insurance premiums deserve a careful look, but we clearly don't want a system in which some institutions conclude that paying a high premium is a license to undertake even more risky if not reckless activities.

Similarly, broadening the class of deposits or non-deposit liabilities that are subject to deposit insurance premiums will generate some added money for the insurance funds but it may also exacerbate the moral hazard problem by fostering the notion that it is the institution rather than a class or subset of deposits that is being insured.

My *final* point on the distinctly negative side of the ledger relates to the evident breakdown in ethics and values in pockets of the financial market place. While I may not have the perspective to judge whether the problems we are seeing are worse or more frequent than has occurred in the past, one cannot help but be troubled by recurring reports of patterns of conduct which are either in outright violation of law or regulation, or which are designed to stay just inside the letter of law and regulation while flaunting its spirit.

In banking and finance, public confidence is the bottom line and systemic risk is the ultimate threat. Recognizing this, we -- like all nations -- have chosen

> to buttress public confidence in the banking and financial system with the so-called public safety net. But in reality, public confidence should rest on something more fundamental and that is the standards set by institutions and individuals to protect not only their financial well-being but, even more essentially, their professional reputation.
>
> An indispensable source of continuing strength for the financial system must be the self-discipline of its participants and the preservation of incentives which reward integrity and fair play and also provide a framework in which it is clear that the costs of ripping off the system -- financial and reputational -- are much greater than the possible gains to be realized. However, when equity stakes are minimal, when compensation can run well into the millions and when the system socializes losses, that delicate balance can be undermined. It is for that reason those who abuse the system must be penalized severely. As we seek to maintain that balance, however, we must also

> take great care so that we do not penalize the prudent and the disciplined for the abuses of the reckless and irresponsible. "

To summarize, while efforts aimed progressive reform of our banking and financial system are making little or no headway, the world is not standing still. To be sure, the system has demonstrated remarkable strength and resiliency; to be equally sure, some piecemeal progress has been made in important areas. But, overall, the stresses and strains, the distortions, and the competitive and prudential anomalies that grow out of a structure that is increasingly outdated and increasingly out of line with the clear trend of developments in the rest of the world, are becoming more apparent and more troublesome.

The priorities are clear enough: first, a comprehensive program to remedy the situation in the thrift industry; second, comprehensive market sensitive reform and restructuring of the banking and financial system; and third, the adaptation of supervisory and other safety net arrangements to best fit the underlying structure of the system for the future. That is a large agenda especially on a Congressional calendar that is already overcrowded. However, with so much at stake I believe we must find the will and the way to get on with the task. Failure to get ahead of potential problems carries with it the all too obvious risk that reform will ultimately take place only in the context of problems instability and a loss of international competitiveness. We all know that in those circumstances reform could easily prove to be regressive, not progressive.

Thank you.

REMARKS BEFORE THE
INSTITUTE OF INTERNATIONAL BANKERS
MAY 23, 1989
NEW YORK, NEW YORK

BY E. GERALD CORRIGAN, PRESIDENT
FEDERAL RESERVE BANK OF NEW YORK

Good evening ladies and gentlemen; it is a great honor to again have the opportunity to address this distinguished group of international bankers. When I addressed this group four years ago, I dwelled at some length on the process of financial innovation and the globalization of banking and financial markets. Drawing on that earlier address, I thought it might be useful to revisit the general subject to see just what has -- and has not -- occurred relative to some of the issues that I raised on that earlier occasion.

Allow me, therefore, to briefly restate a few of the issues I raised four years ago. Specifically, and having pointed to the clear benefits of the process of financial innovation, I went on to say that there were some aspects of it which would warrant careful monitoring over time. I cautioned that:

-- Financial innovation cannot eliminate interest rate, exchange rate or credit risk. Moreover, in the event of shocks or instability, some of the risk -- no matter how transformed or redistributed -- can find its way back to depository or other financial institutions.

-- It is also possible -- but by no means certain -- that financial innovation may encourage relatively faster growth in debt. The end result of this may be a situation in which the economy as a whole is simply taking on too much debt relative to its equity base and to its income producing capabilities.

-- Similarly, other innovations which are designed to increase liquidity may not change the underlying liquidity of the economic assets being financed, or the short-term financial liabilities which ultimately may support them.

-- Financial innovation is introducing greater elements of complexity and inter-dependencies into the system.

-- Finally, financial innovation raises questions about the manner in which the process of monetary restraint may work. One line of reasoning would suggest that innovation in banking and financial markets is tending to make the process of restraint more efficient simply because the burden of restraint is dispersed throughout the economy. However, that same line of reasoning could also mean that achieving a given level of restraint -- however defined -- may require a higher level of interest rates than would otherwise be the case. We must also keep in mind that in a setting of globally integrated money and capital markets, relatively small interest rate changes may give rise to substantial shifts in capital flows with potentially large impacts on exchange rates and economic activity.

My fundamental point in raising those questions was to suggest that some of the long-run implications of the financial market developments of four years ago might not be fully evident for some time to come.

Four years is not a long time. But, in this case, the developments that have been crammed into four years is nothing short of astonishing and the full implications of all of this are still far from clear. The proliferation of new instruments and new bells and whistles on older instruments has, if anything, accelerated; the complexity and speed of financial transactions have, if anything, increased; the credit, liquidity and operational interdependencies on a global basis have, if anything, grown tighter; and, the nature and degree of competition in the financial marketplace have grown to an extent that the thinness of spreads and margins on many instruments and in many markets are broadly symptomatic of conditions of overcrowding in the marketplace. Finally, and at the risk of mentioning the unmentionable, it seems clear to me that some of the dangers I cautioned about in 1985 did manifest themselves in a rather unambiguous fashion in those difficult days of late October, 1987. Whether by good fortune, good design, good policy or some combination of all three, the financial system and the economy itself survived the October market break with remarkably little damage. But, the question still remains as to whether we have done all that can be done to adjust procedures and policies to the realities of today's global marketplace in a way that ensures that we will get the full benefit of more efficient markets and the benefits of a safer and sounder system. Indeed, I need not remind this group that at the end of the day it is the stability of the financial system as a whole which must command our greatest attention.

Looked at from that perspective, the past four years have witnessed some truly impressive gains in efforts to strengthen the infrastructure of the financial system. For example:

-- Major institutions have expended vast amounts of time and money in order to strengthen operational and control systems. Indeed, some are now approaching the goal of globally integrated real time monitoring and control systems.

-- Capital positions have been materially enhanced. As an illustration, I expect that by the end of this quarter all of the major New York banks will exceed the B.I.S. tier I capital minimums using 1992 capital definitions. In fact, even now many of those institutions exceed the 1992 minimal standards by a fair margin. Parallel developments at other institutions in other markets are also occurring.

-- We have made genuine progress in moving toward a much higher degree of convergence in capital and prudential standards for banking institutions on an international scale -- a development which I regard as a remarkable illustration of international cooperation and coordination.

-- Important strides have also been made in the much needed effort to strengthen clearing and settlement systems for financial and derivative financial instruments. The latest illustrations of this are the recent publication of the Group of Thirty study on clearance and settlement procedures for equities and the B.I.S. study on netting arrangements both of which I enthusiastically commend to the attention of those who have not already read them.

-- Finally, in many countries, and in the European Community as a whole, major strides are being made in adapting the basic legal and institutional structure of the financial market to the realities of the day and beyond. Sadly, such efforts are making little or no real

progress here in the United States. Indeed, with Japan apparently now seriously considering the significant liberalization or perhaps even the essential elimination of Article 65, the U.S. could soon become the only major nation with a fragmented banking and financial system. This result can only work to the competitive disadvantage of U.S. firms -- banks and nonbanks alike -- and U.S. markets.

These positive developments that have taken place over the past four years tell only a small part of the story of efforts to respond constructively to developments in the marketplace. They and others I have not cited in the interest of time are necessary, but they are not sufficient and they provide no room whatsoever for comfort or complacency. We are trying to hit a very rapidly moving target. Thus, while much has been done, much more needs to be done and done promptly. Let me close, therefore, by stressing three particularly important tasks that lie ahead.

-- First, as soon as the thrift industry legislation is complete, the appropriate committees of the U.S. Congress must promptly get on with the task of implementing broad based, progressive and market sensitive reforms to the basic structure of the U.S. banking and financial system. In stressing market sensitive reform I have in mind several considerations, not the least of which is that we not get too carried away with firewalls. As I have strongly maintained for many years, firewalls serve a very useful and necessary purpose but taken to an extreme they can: (1) essentially cancel out the competitive and economic advantages associated with combining different classes of financial activities under common ownership; (2) create unnecessary and potentially dangerous tensions in our relations with foreign institutions and their supervisors; (3) impede the international competitiveness of U.S. firms; and (4) give rise to a false sense of security concerning the stability of the banking and financial system as a whole. These dangers seem to me to be all the more acute to the extent firewalls are imposed not only between the bank and its cross stream affiliates

but also between the bank-holding company and its non-bank subsidiaries. Moreover, firewalls can never be a substitute for sound management or for a system of effective, yet flexible, supervision.

-- Second, building on the success of the recent past we must further adapt supervisory policies both domestically and internationally. For example, the B.I.S. capital framework must be adapted in a way in which it can take explicit account of market and/or price risk. That, in turn, will tend to bring into sharper focus the need to achieve a higher degree of harmonization between banking and securities or capital market supervisory systems. That will not be easy on the domestic front but achieving that goal internationally will be even more difficult since the effort must overcome vast differences in practice, structure and philosophy. Some initial steps in these directions are now underway here and abroad but as I see it this effort will represent one of the great challenges we face in the period ahead.

-- My third priority is less concrete but probably as important as the others. What I have in mind is the need on the part of financial market practitioners to take greater account of the bigger picture -- the longer view. In saying this, I must confess that I have a sense of unease about the extent of financial engineering we see in today's marketplace. The ultimate question, of course, is whether all of this is really helping to better allocate scarce savings on a global basis in a manner than is consistent with economic growth, hard investment and rising standards of living. As a related matter, I also have to wonder about the sustainability of arrangements in which individual firms engage in tens of billions of dollars in transactions in securities and foreign exchange trading and comparable volumes of transactions in swaps, caps, collars, forwards, futures and options in order to generate relatively modest amounts of income but income that, at the margin, is vitally important to the bottom line.

It is the natural order of things that I, as a central banker, should worry about these matters. After all, I'm paid to worry. But, I'm also paid to understand the realities of the financial marketplace. In looking at those realities, I remain convinced that the burst of innovation we have seen and continue to see can and should be a distinct plus for the global economy. But, the full measure of that success will only come if the dictates of discipline and prudence remain at the forefront of the process. The freedom to innovate, to create, and to challenge the orthodox -- like any freedom -- brings with it responsibilities. In this case, the burden of those responsibilities is to see to it that the process of change and adaptation is consistent with the workings of a safe, sound and stable system. I believe we are up to achieving that goal, but it's going to require a lot more work and a lot more vision.

Thank you.

EXCERPT FROM
STATEMENT BY
E. GERALD CORRIGAN
PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

JUNE 18, 1987

V. The Separation of Banking and Commerce

While the current debate regarding reform of the banking and financial system has many controversial aspects, one source of debate that is especially crucial to the deliberations of the Congress relates to whether, as a matter of public policy, we should preserve a separation between banking and commerce.

I have spent countless hours deliberating the wisdom of maintaining the separation of banking from commerce. Having done that, I can say, Mr. Chairman, that if my views have changed, they have changed in the direction of further solidifying my judgment that it is in the public interest to have a legislative framework that prevents commercial firms from owning and controlling banks unless there is some absolutely compelling reason to permit such combinations. Since I see no such compelling reason at this time, I remain opposed to such arrangements.

The case for permitting commercial firms to own and control banks is based on a view that says either that there is nothing inherently wrong with such combinations or that such combinations can provide economic benefits in a framework in which regulatory and/or managerial protections can be put in place that will insure that public interest considerations are adequately served. I, for one, have grave doubts on both accounts. In order to make that case, let me begin with several points of reference.

First, when society vests with a select group of institutions certain privileges such as deposit insurance, access to the payments, credit and liquidity facilities of the central bank and the implicit sanctions of official supervision, something of a social compact is created whereby the institution accepts certain responsibilities, most notably the responsibility to conduct its affairs in a safe, prudent and impartial manner.

Second, the central question at issue with respect to the banking-commerce separation doctrine is whether it is desirable for wholly unregulated, unsupervised commercial concerns to be able to own and control depositories having access to the overall Federal financial safety net. In seeking to answer the question we should, for starters, keep in mind that if we in the U.S. go that route, such arrangements would be unusual among the industrial countries of the world in that in no other major countries are banks, as a general matter, owned and controlled by commercial companies. To be sure, in some countries, such as Germany, banks have greater flexibility in the extent to which they may hold

equity interests in commercial companies than is the case in the U.S., but commercial ownership and control of banks are not common.

Third, if, as a legal matter, commercial concerns are able to own and control banks, it seems apt to ask would they choose to do so and if so, why? To some extent we know the answer to the first question since at least some commercial firms already own insured depositories and others seem to have an interest in doing so. In that setting, the operative question is why they would wish to do so. Here there can be only three possible answers. First, among the alternative uses of capital, they visualize the relative returns available in banking as superior; second, they see synergies in the combination of banking with existing lines of business that will permit them to maximize the overall return on capital; or, third, they see economic advantages in gaining access to one or more of the privileges associated with banking such as access to the market for insured deposits or direct access to the payment system. Of course in reality, the motivation might well reflect some combination of the above factors. The key point, however, is that if the motivation for commercial companies to own banks is even partly related to the second and/or third explanations cited above, there are clear dangers in permitting such combinations. *Fourth*, one might be more inclined to run those risks if there is some absolutely compelling public policy reason to do so. Satisfying the business interests of a relative handful of corporations does not strike me as a compelling public purpose. On the other hand, if there was (1) strong evidence of an absence of competition in banking or (2) strong evidence that combinations of banking and commercial concerns would unleash powerful new economies of scale which did not run afoul of public interest considerations, or (3) if the banking industry was suffering a chronic shortage of capital, one would look at banking and commerce in a different light.

While a case can be made that the capital base of the banking industry should be further bolstered, it is by no means clear that the only way, or the best way, to remedy that problem lies with permitting commercial firms to acquire and

control insured depositories. Indeed, it is not even clear that permitting commercial firms to make such investments would materially augment the true capital base of the banking industry. Whether, and the extent to which, that result is achieved would depend, among other things, on the nature of such investments, the prices paid and the manner in which the investment is financed by the commercial company. More importantly, at the end of the day capital will be attracted only by underlying profitability. Merely permitting commercial ownership of banks would seem to do little to change that unless the owners were permitted to push extensive interrelationships which is the very source of my concern. *Fifth*, a final consideration which is of relevance in evaluating the case for or against the separation of banking and commerce is the rather straightforward matter of how businesses conduct their affairs. That is, when we look at the manner in which large diversified bank holding companies, financial conglomerates or even commercial-financial firms are managed, do we see -- especially in times of stress -- an integrated approach to management, or do we see parents and offspring each willing and able to go its own way even when one or the other is faced with adversity?

While some observers cite a limited number of examples which they believe provide evidence of failsafe managerial firewalls, I believe that any objective examination of the evidence -- evidence that runs the gamut from advertising to episodes in which firms have taken large losses even in the face of ambiguities about their legal liability -- leads conclusively to the view that firewalls are not failsafe and that, far more often than not, large financial concerns are managed and operated as consolidated entities. Looked at differently, the mere need to set up an elaborate system of firewalls says something about the basic issue of whether it makes good sense to prompt such combinations in the first place.

Taking all of those considerations into account, there are two major classes of risks that must be considered if we are prepared to permit the blending of commerce and banking. The first set of risks are the historic concerns about concentration, conflicts, unfair

competition and breaches of fiduciary responsibilities. Interestingly enough, even most proponents of blending banking and commerce acknowledge that those risks are present. In response to this, the proponents suggest that the problem can be dealt with by regulation. However, if regulation is effective, it will, by definition, eliminate the synergies of any such combination such that the commercial firm in question is left only with a truly passive investment. If that is the objective of the commercial firm, there is nothing to prevent such firms from making large equity investments via the open market in any number of banking or financial entities so long as any one such investment does not achieve control over the company in question. Indeed, a commercial firm can buy up to five percent of the stock in any one bank without even having to disclose such an investment.

The second set of risks associated with permitting the merging of banking and commerce are the dangers that such arrangements will involve the de-facto extension of parts of the safety net to any firm that would own and control banks. In response to this point, the proponents argue that the situation is really no different than the situation we have today with the bank holding company. In fact, there is a very big difference and that difference is that the bank holding company -- as an integrated whole -- is subject to official supervision. Moreover, in the reform plan I have suggested, all component parts of a bank or financial holding company would be subject to some form of official supervision, much as they are today, and the company as a whole would be subject to at least a degree of consolidated official supervision.

There is another way to look at the problem. Namely, I assume that even the proponents of merging banking and commerce would agree that the acquisition of a bank by a commercial company would be subject to some sort of official approval process. I assume they would also agree that a part of that application process would have to focus on the financial strength of the acquiring firm as well as the regulatory and managerial firewalls which they agree should be constructed. I assume they would further agree that some such applications would be approved while others would be denied and that some form of ongoing monitoring would be necessary. In making this point, it should be emphasized that commercial firms wishing to own banks undoubtedly will not be limited to a few "blue chip" companies. To the contrary, the list of potential acquirers will include all comers -- something I am convinced we should be especially sensitive to in this

era of merger mania in which even solid firms can be forced into elaborate defensive financial strategies which undermine their balance sheets.

Therein, of course, lies the dilemma; that is, even the official act of approving an application of a commercial firm to acquire a bank seems to carry with it the extension of at least some elements of official oversight to the acquiring firm in a manner which brings with it -- at least by implication -- an official blessing of the transaction and the relationship in question. As I see it, this subtle but certain extension of the safety net is not something we should take lightly since we must be prepared to live with the consequences in foul weather as well as in fair. Indeed, at the extreme the logic of the matter is unavoidable; if the bank cannot be fully insulated from the entity as a whole, the consequences are either that (1) the safety net surrounding banking will have to be extended -- at least to an extent -- to all who would own and control banks, or (2) the safety net should be eliminated altogether.

(end of excerpt)

The **Chairman**. Let me thank you for an excellent statement and one that reflects years of work and thought. We've had a number of conversations in hearings here and I very much appreciate the quality of the thought that you've given us here today.

Mr. Reed, let us go to you next and we'd be pleased to hear from you at this time.

STATEMENT OF JOHN S. REED, CHAIRMAN, CITICORP, NEW YORK, NY

Mr. **Reed**. Mr. Chairman, you have caused us to come here today to talk about a subject that is of extreme importance. I am personally delighted to be able to participate and I agree with many of the comments that have been made this morning as to the importance and the immediacy of these concerns.

If I could have my formal testimony made part of the record, I will quickly summarize my comments so as to move this forward.

What I suggest is frankly very straightforward and it was mentioned earlier by Senator Garn. Namely, I support with my colleagues here a major restructuring of the laws that shape the U.S. financial industry.

There are two reasons I have a sense of urgency about this task.

First, the international environment is changing rapidly and the structure of the U.S. financial industry really is not well-equipped for the future as we see it emerging. We can already see some of the strains our industry is experiencing as it tries to meet foreign competition. Frankly it is very easy to look forward and see that the existing regulatory structure is not adequate for the requirements of our industry, but even more importantly, not adequate for the needs of our society.

IMPACT OF A STRONG FINANCIAL SERVICES INDUSTRY

A strong financial services industry should be encouraged not only for the direct effects it has on employment and so forth, but even more importantly for the effects it has on the economy as a whole. We are intermediaries. If we can serve our customers, both individual households and corporate customers well, then we will be serving our country well. It is fair to say that the industry, with its current regulatory structure, is not particularly well-positioned to meet the needs and requirements we see coming at us in the worldwide system.

Second, if you simply look back at some of the problems we have experienced in our country over the past 5 to 10 years, one cannot help but conclude that some of these problems are symptomatic of an inappropriate regulatory structure. The current structure has had the effect of concentrating risk where it need not have been concentrated. This has cost the U.S. taxpayer money and it will continue to do so.

Looking at the record, both prospectively for 1990 and beyond, as well as historically, one can point to many reasons why it is important to change the structure that we have. I am sure these facts are well-known to you since they have been discussed before this committee on many occasions.

My recommendations are really very straightforward and really very simple. There is a need for a substantial liberalization of the existing structure. I have five specific points. First, we should erase the barriers between investment banking and commercial banking as they today exist. These barriers are not reflective of the modern world nor of the role that investment and commercial banks have to play vis-a-vis their customers. Markets would be better served if the barriers were removed. The existing regulatory structure can provide appropriate safeguards.

Second, it would be appropriate to permit the gradual erosion of the distinction between savings and loans and commercial banks. As you know, Citicorp owns five savings and loans as well as a number of commercial banks. Our own experience shows that the distinction between those legal entities is not truly relevant in the customer marketplace and does not particularly benefit American society. I would therefore recommend that over a period of time the distinction between S&L's and commercial banks be eliminated.

GEOGRAPHIC COMPARTMENTALIZATION

Third, the current geographic compartmentalization of the financial services industry in the United States is not appropriate. The States are acting to erase this on their own behalf but it is a trend which should be supported at the Federal level. The very positive development of many of the regional banks in the United States today stems from their ability to expand geographically in adjacent markets. At the same time, some of the negatives we have witnessed, particularly in Texas, come about because geographic compartmentalization forced a concentration of risk on a number of well-managed banks operating in a depressed local economy. In contrast, Canada suffered the same types of economic problems, and had an equal dependence on energy industries. Yet their financial institutions, because they were able to average across the entire country, did not go through the difficulties that banking institutions in Texas experienced.

So I think that the geographic compartmentalization is a source of concentration of risk that we simply cannot afford in this country.

Fourth, the barriers between commercial banking and insurance need not be maintained. We see around the world—and there is no reason to believe that it would be different in the United States—that from the consumer's point of view there are significant economies and efficiencies of distribution from permitting banking and insurance to come together. Of course, there is a need to maintain some separation in order to facilitate regulation. But Citicorp operates a banking institution in Belgium, for example, where many of our banking products are distributed by insurance agents. You will find that even in the United States the agency structure will stay in place if these two industries are allowed to come together more closely.

Finally, I recommend that over a period of time deposit insurance, which today covers 100 percent of deposits up to the $100,000 limit, gradually be phased back so that it would cover between 85 and 90 percent of deposits.

Over the years I've come to have tremendous respect for the intelligence and the sensitivity of consumers in this country. My own career in Citicorp came up through the retail side of our business and I've learned that consumers are highly sensitive to what is going on in their financial institutions. If consumers were subject to a small degree of risk with their savings deposits—say by limiting deposit insurance coverage to 90 percent of deposits in excess of $50,000—they would become quite sensitive as to the nature of the financial institutions with which they deal and they would apply pressure on those institutions to behave in ways that were more prudent. I believe this would go a long way toward establishing market discipline without in any important sense removing the safety net from these deposits.

In sum, I recommend that we very substantially liberalize the structure of the financial system in this country so as to permit it to evolve in what I consider to be a more healthy, more competitive, and a more coherent state.

I must say that I agree with many of the comments that Mr. Corrigan has made. I did not specifically touch on his comments about the regulatory role of the Federal Reserve, but I can associate myself with his conclusions there. I do believe that the Federal Reserve's day-to-day contact with the marketplace does wash over its regulatory responsibilities in a healthy way. And I agree with the idea that it is important to get the structure of our industry in place before we look at the structure of the regulatory apparatus.

With regard to capital, our own history shows that it is most important to get the basic business structure right first, and worry about capital second. There is no question that the banks in Texas that got into trouble were properly capitalized—even well-capitalized and also well-managed. These banks were simply unable to outrun regional economic distress because of their concentration in a narrow geography. No amount of capital will overcome a fundamentally flawed structure. So while I certainly would agree that financial institutions should be appropriately capitalized, we cannot rely on the capital structure of financial institutions to overcome inherent deficiencies in the structure of the industry itself. Thank you, Mr. Chairman.

[The complete prepared statement of John S. Reed follows:]

SUMMARY OF TESTIMONY

JOHN S. REED
CHAIRMAN, CITICORP

JULY 13, 1989

A major restructuring of our financial system is necessary. Restoring the U.S. financial system to world-class status is crucial not just for the health of the industry, but more importantly, for the economy as a whole. Decisions made by this committee will materially determine whether our nation continues to be a leader in the world economy going into the 21st century, or whether it sinks back to secondary status.

The global competitive environment is changing rapidly. More and more nations are restructuring their financial systems to make them more efficient and competitive internationally. But the significance of the moves thus far is dwarfed by the momentous changes that will result from the "1992 project" in Europe. Financial services firms in the U.S. are justifiably concerned about the impact of the 1992 project on their own international competitiveness. But the stakes are much greater than that for the U.S. as a whole. The European Community is eliminating virtually all internal barriers that have limited competition and reduced economies of scale and scope in a broad range of industries. The financial services component of this effort is extensive. The goal is not just a more competitive financial services market, it is a more competitive Europe.

As the 21st century gets underway, organizations and strategic alliances which have at their core a commercial bank, a fully integrated investment bank/securities operation, and an insurance company can be expected to dominate global financial markets.

The U.S. Is Lagging.

While much of the developed world is busy laying the foundation for a financial system for the next century, the U.S. financial system remains anchored firmly in the past. Less than half the states will have full interstate banking by 1992. As for the activities and affiliations of depository institutions, the Bank Holding Company Act and the Glass-Steagall Act can only be characterized as protectionist -- if not in intent, at least in their consequences. These laws compartmentalize financial services in ways that are becoming increasingly

anachronistic. They are a source of risk and inefficiency in the system.

Limitations on the nonbanking activities of bank holding companies and the clumsy "firewall" structure raise the cost of financial services to customers and make it difficult for financial services organizations to be responsive to their needs. In addition, they reduce the industry's ability to attract management and capital, and they inhibit the development of the type of innovative products, risk management techniques and distribution strategies that are now being developed by major financial services providers overseas.

What Needs to be Done.

In today's world, it is simply not possible for U.S. financial services organizations and U.S. financial markets to be more onerously regulated than in other financial centers and still be competitive. Unless the Congress can fashion a world-class legal framework for financial services, U.S. financial services providers will become increasingly less effective.

The "Depository Institution Affiliation Act" combined with the repeal of laws intefering with interstate operations would be a step in the right direction. This legislation would permit any business to own a depository institution as a separately capitalized subsidiary of a holding company, regardless of its other business activities. It also contains new safeguards to protect the deposit insurance funds.

In essence, we need a framework that: (a) permits firms intermediating global capital markets on behalf of their customers to do so efficiently, whether they are commercial or investment banks; (b) allows the integration of the traditional banking and savings and loan industries; (c) allows the integration of insurance and banking with appropriate industry safeguards; and (d) erases geographic barriers within the United States.

Deposit Insurance Reform.

The FSLIC crisis is an appalling example of the weaknesses in the deposit insurance system. Congress and the Bush Administration deserve credit for working to restore discipline to the S&L industry by strengthening capital requirements. Nonetheless, these reforms do not go far enough.

The fundamental problem is that the protection provided by the deposit insurance system now extends far beyond what was originally intended. Safeguards designed to protect small savers are being applied to financially sophisticated professionals. This has had a corrupting influence on the entire financial system -- directly because it does not reward prudence and sound judgment, and indirectly because it forms the justification for burdensome government policies that reduce the efficiency of the financial system.

In my judgment, this situation will only change when deposit insurance coverage is limited to $100,000, de facto as well as de jure. Better still, coverage should be rolled back.

Federal regulators have the tools to expose large depositors and other creditors to losses when a failure occurs, while preserving the liquidity of deposit accounts. They can safely apply those tools to banks and S&Ls of all sizes. No bank is too big to be reorganized.

LDC Debt.

The current LDC debt situation has to be seen in the proper perspective. We have made some progress in the past few years. There is a widespread notion that the banks and the LDCs are adversaries. This notion is false. We have a common interest in the economic viability of the LDCs. Citicorp has been in Latin America for nearly 100 years. We plan to stay there and to grow with these nations.

Right now, negotiations with Mexico are at an extremely sensitive stage. Once an agreement with Mexico is completed, we will than be in a better position to assess the Brady Plan and its prospects for dealing with other debtor nations.

The LDC debt problem is not a problem that is well-suited for a legislative solution. The situation in each of the debtor nations is different and must be approached on a case-by-case basis. Moreover, U.S. banks hold less than 30 percent of the debt. Nothing is gained by applying pressure only to U.S. participants.

Good morning. I am John Reed, the Chairman of Citicorp. I am pleased to be here today to exchange views on the challenges and prospects facing the financial services industry in the coming years. I take the timing of this hearing and the care with which it has been organized as an indication that this Committee is ready to take the action necessary to move the financial services industry in the United States into the twenty-first century. The agenda of this Committee should be nothing less.

The Revolution in Financial Services

In recent years, this Committee has heard several witnesses discuss the profound changes that technology and globalization have brought about. The significance of these changes should not be underestimated. The vision of an integrated world economy is already a reality, but we are just at the beginning of an ongoing process. In the years to come, it is virtually certain that international trade will continue to grow faster than domestic economies and international banking and finance will continue to grow even faster than trade.

A global economy mandates global finance. The needs of financial services customers today are not limited by geographic boundaries nor by historical distinctions between financial products. Whether they seek to raise capital or invest it, their perspective is broad and it is global. This is true for multinational businesses which must fund operations in dozens of countries; it is true for investors who seek the advantages of global diversification; and it is true for ever more mobile individuals who desire access to their assets anywhere in the world.

More and more nations are restructuring their financial systems to make them more efficient and competitive internationally. They are doing so because it makes good economic sense. Job creation, physical investment and the efficient allocation of a nation's scarce capital all depend on well-functioning and cost-effective capital markets. Both Canada and the United Kingdom have recently completed significant restructurings, and further changes are on the horizon in Canada, Japan and Switzerland. But the significance of the efforts thus far is dwarfed by the momentous changes that will result from the European Community's 1992 project.

Financial services firms in the United States are justifiably concerned about the impact of the 1992 project on their own competitiveness in the global financial services market. But the stakes are much greater than that for the economy as a whole. The primary purpose of the 1992 project is to enhance the competitiveness of the European

Community in the world economy. The primary means to this end is the elimination of virtually all internal barriers that have limited competition and reduced economies of scale and scope in a broad range of industries. The financial services component of this effort is extensive. EC directives touch on virtually every aspect of financial services, including insurance, banking, securities, electronic payments and an important related area, telecommunications. The goal of these directives is not just a more competitive financial services market, it is a more competitive Europe.

In preparation for 1992, countries within the EC are rapidly dismantling the barriers between banking, securities and insurance. Universal banking, which permits full integration of securities and banking activities, is likely to become the norm. Three EC countries -- France, Germany, and The Netherlands -- already have universal banking, while in Belgium, the United Kingdom and Spain, banks may own securities and insurance companies, and these companies may own banks. These types of structures permit financial services organizations to attract management and capital, to balance risk, and to efficiently deliver a full range of banking, insurance and securities services to their customers. Regulation of these multiservice firms is on a functional basis, essentially the way American Express is regulated in the United States. In particular, there are generally no holding company capital requirements overseas, and few "firewalls" between banks and their non-bank affiliates, aside from simple lending limits.

There are many joint ventures and acquisitions now in the works by European companies. Banque Nationale de Paris, France's largest bank, and Union des Assurances de Paris, its largest insurance company are planning an alliance to boost cross-marketing of financial services products. Deutsche Bank, West Germany's largest bank, recently announced that it is getting into the life insurance business through a subsidiary. In the United Kingdom, a major clearing bank, Lloyd's, recently purchased Abbey Life, a top insurance company. And Europe's biggest insurance company, Allianz, recently announced a marketing arrangement with West Germany's second largest bank, Dresdner Bank.

Organizations and strategic alliances such as these, which have at their core a commercial bank, a fully integrated investment bank/securities operation, and an insurance company, can be expected to dominate global capital markets as the 21st century gets underway.

The United States Is Lagging.

In sum, the global competitive environment is changing rapidly. But while much of the developed world is busy

laying the foundation for a financial system for the next century, the U.S. financial system is anchored firmly in the past. It is frankly appalling that European nations will have removed virtually all geographic and product-line barriers affecting financial services by 1992, while our system remains balkanized.

Less than half the states will be participating in full interstate banking by 1992. As for the activities and affiliations of depository institutions, the Bank Holding Company Act and the Glass-Steagall Act can only be characterized as protectionist -- if not in intent, at least in their consequences. Financial institutions perform a limited number of common functions -- they process transactions, serve as intermediaries, manage information, give advice and trade assets. That is why the common sense benefits from combining services are potentially so large. Yet current laws compartmentalize financial services in ways that are increasingly anachronistic. They are a source of risk and inefficiency.

A vivid example is the convergence of commercial banking and securities services, which are now so similar from a business standpoint and so closely intertwined from a customer standpoint that any distinction between them is artificial. The risks and the marketing procedures involved in loan syndications and private placements, for example, are fundamentally the same as those involved in underwriting and distributing securities. Yet loan syndications and private placements have been done by banks for years, while the strictly limited securities activities now permissible for bank holding companies can only be done in a separate subsidiary with separate capital, different people and duplicate support functions.

Another example is insurance. Amendments to the Bank Holding Company Act in 1982 almost completely separated banking and insurance. But the gains from permitting banking and insurance organizations to affiliate are potentially very large. These organizations both deal in risk-transfer, risk management and distribution. They both function as financial intermediaries, receiving funds from depositors or policyholders and investing them in comparable assets. The techniques they use for assessing and containing risk are often similar. The products they offer are in many cases functionally equivalent -- there is little difference, for example, between letters of credit and financial guarantees, or between the annuities offered by life insurers and the CDs offered by banks. With thousands of branches nationwide, banks would be cost-effective distributors of insurance products. In turn, many life insurance companies are interested in providing their agents with both life insurance and banking products to sell.

In sum, limitations on the nonbanking activities of bank holding companies and the clumsy "firewall" structure in the United States raise the cost of financial services to customers and make it difficult for financial services organizations to be responsive to their needs. They reduce the industry's ability to attract management and capital, and they inhibit the development of the type of innovative products, risk management techniques and distribution strategies that are now being developed by major European financial services providers.

Financial services customers have become very skillful in assessing their available alternatives on the basis of the quality of services and their cost. If they can not obtain the range and quality of services they need from providers in the United States, many of them will simply obtain them elsewhere -- from a foreign competitor, or maybe even from a foreign office of Citicorp. One of the great ironies of the present framework is that bank holding companies are permitted to offer services overseas that they are unable to offer at home. As a result, we as a nation are exporting jobs, capital, and know-how.

What Needs to be Done.

It is essential that we restructure our laws and regulations. In today's world, it is simply not possible for financial firms and financial markets in the United States to be more onerously regulated than in other financial centers and still be competitive. Our industry is the most innovative and resourceful in the world. Nonetheless, in rankings of institutions by size or by extent of cross-border activity, we are slipping further and further behind our foreign rivals. In addition, the problems of the savings and loans, the farm banks and the Texas banks are clear signs of failure to serve our own people and businesses. Unless the Congress can fashion a world-class legal framework for financial services, U.S. institutions will become increasingly less effective.

In 1988 the Senate passed banking legislation in an effort to modernize parts of the U.S. financial system. But the global competitive environment and domestic needs are changing rapidly. You and your colleagues in the Congress must now look beyond the compromises that were crafted then and take a bold approach to financial restructuring.

The Depository Institutions Affiliations Act, introduced in the Senate as S. 530, would be a step in the right direction. This legislation would permit any business to own a depository institution as a separately capitalized subsidiary of a holding company, regardless of its other business activities. It also contains new safeguards to protect the deposit insurance funds.

The Depository Institution Affiliation Act would go a long way, but not all of the way, toward meeting the industry challenge. In essence, we need a framework that: (a) permits firms intermediating global capital markets on behalf of their customers to do so efficiently, whether they are commercial or investment banks; (b) allows the integration of the traditional banking and savings and loan industries; (c) allows the integration of insurance and banking with appropriate industry safeguards and supervision; and (d) erases geographic barriers within our common market of the United States.

Benefits of Financial Restructuring.

Consumers would benefit enormously from breaking down barriers to competition in financial services for a number of reasons. It would ensure that consumers get market rates on their savings and on their borrowings; it would generate new products and greater convenience; and it would extend the availability of credit. Our business community would also benefit from more competitive, responsive, and market-oriented finance. In the process, overall productivity, the use of capital and the competitiveness of the United States economy would be enhanced.

Nonetheless, some financial services providers have actively resisted the integration of banking with other lines of business. They raise the specter of anti-competitive practices, abusive tie-in arrangements and conflicts of interest. They say the safety and soundness of the banking system would be threatened. There is little support for these claims.

When consumers buy any number of complicated goods and services from refrigerators to VCRs, they face many of the same information problems they face in buying banking, insurance, securities and real estate services. They need to know whether the seller is offering a good product and whether the seller can be relied upon to stand behind it. How do consumers make these choices? The answer is that they often rely on the reputation of an established retailer to ensure that they get good quality for their money.

Late in the 19th century, organizations such as Marshall Field, J.C. Penney and Sears revolutionized retailing by staking their reputations on the quality and price of the goods that they sold. In addition to the convenience these retailers offered, the fact that they sold a broad range of items made them willing to go to great lengths to satisfy their customers. After all, their reputations were essential to their commercial success. This proved to be enormously beneficial to consumers.

Customers could go to a retailer offering a diverse product line, buy a complicated product they did not fully understand, and be confident that they were getting a fair value.

For the same reason, consumers would welcome the opportunity to buy financial services as part of a larger relationship in which the seller's incentive to provide the best service is especially strong. This is particularly true for non-routine transactions, such as acquiring a major insurance policy, in which complex information hurdles make it difficult for consumers to compare terms and costs. The incentive for a financial services organization like Citicorp to offer quality services to their customers is strong indeed for the simple reason that we want to keep our customers satisfied. We would not want to jeopardize an ongoing relationship in a single transaction.

In sum, breaking down financial barriers would result in significant consumer benefits, not consumer abuses. Some consumers are enjoying these benefits right now. Consumers in the United Kingdom, for example, now buy about 60 percent of their insurance through banks. Consumers in several midwestern states and, most recently, in California are also able to buy insurance from banks and many are doing so. These consumers obviously think they are getting a good deal either by virtue of lower price or greater convenience. The combination of banking and insurance activities has not been accompanied by claims of abusive selling practices. It has not threatened the solvency of any banks. And it has not eliminated the need for insurance agents.

Nor would breaking down barriers to competition inevitably lead to high levels of concentration and monopolistic practices. No one is worried that Sears Roebuck, with sixty million credit card customers, will end retail merchandising competition. No one is afraid that Merrill Lynch, with over seven million active customers and branch offices in forty-nine states, will gobble up its competitors and control everyone's financial assets. The concern that a small number of commercial banks would come to dominate the financial marketplace is equally unwarranted.

Deposit insurance Reform.

Would breaking down barriers to competition pose new risks to the safety and soundness of the banking system? It is instructive to note that only one U.S. bank holding company is rated AAA, and then only by a single rating agency, while there are at least seven European universal banks with that rating by both Moody's and Standard and Poor's. Four of these have grandfathered securities affiliates that are free to underwrite and to distribute securities throughout the United States without firewalls between the bank and the securities company.

Few universal banks operating without branching restrictions in their national markets have failed. By contrast, U.S. banks and thrifts have been failing at rates not seen since the 1930s. Most of these failures have occurred the old fashioned way -- as a result of loans that went bad or interest rate gambles that did not pay off. Geographic and product-line restrictions have contributed to high failure rates by limiting diversification opportunities, while in the S&L industry, fraud and overexpansion fueled by easy access to federally-insured funds have been factors. It is not readily apparent that our compartmentalized system is either safer or sounder.

The FSLIC crisis is an appalling example of the weaknesses in the deposit insurance system. Congress and the Bush Administration deserve credit for working toward a plan to restore discipline to the savings and loan industry by strengthening capital requirements. Nonetheless, in my judgement, these reforms do not go far enough.

The fundamental problem is that the deposit insurance system now extends protection far beyond what was originally intended. Through increases in explicit coverage and the failure resolution policies of the deposit insurance agencies, safeguards that were originally designed to protect small savers are being applied to financially sophisticated professionals capable of making their own credit judgments about the banks with which they do business.

As a result, our system of depository institutions has become far too dependent on deposit insurance. The sad fact of the matter is that hundreds, perhaps thousands, of depository institutions could not survive without the federal deposit insurance sticker on the door. Extensive deposit insurance protection has had a corrupting influence on the entire financial system -- directly because it does not reward prudence and sound judgment, and indirectly because it forms the justification for burdensome government regulations that reduce the efficiency of the financial system. It is in this sense that the deposit insurance problem is also a competitiveness problem.

In my judgment, this situation will only change when deposit insurance coverage is limited to $100,000, *de facto* as well as *de jure*. Better still, coverage should be rolled back. I personally favor subjecting all deposits in excess of some basic amount to a ten to fifteen percent "haircut" in the event of a failure.

Protecting the stability of the financial system does not require full federal protection for all the liabilities of depository institutions. It does require timely intervention by regulators when an institution gets in trouble and better enforcement and supervision. Federal regulators have tools, such as bridge banks and modified payoffs, to expose large depositors and other creditors to losses when a failure occurs, while preserving the liquidity of deposit accounts. They can safely apply those tools to banks and S&Ls of all sizes. No bank is too big to be reorganized.

Other solutions have been proposed. For example, some have advocated "narrow banking," which would require banks to invest only in perfectly safe securities and spin off all other activities, such as commercial lending into separately capitalized affiliates. While this approach would surely solve the deposit insurance problem, it is also much more costly to society. Commercial banks around the world have been combining commercial lending with deposit taking for hundreds of years without the major systemic problems we are witnessing in the S&L industry. These problems are the result of many contributing factors, but they are not the result of combining lending and deposit-taking in the same organization.

Others have proposed risk-based deposit insurance premiums and further refinements of risk-based capital requirements. In my judgment, these are fine-tuning measures. They do not address the core problem, and they are extremely difficult to implement effectively.

LDC Debt.

I would be remiss in not saying a few words about the debt problem of the lesser-developed countries. The current situation has to be seen in the proper perspective. We have made progress in the past few years and we are working very hard see that it continues.

There is a widespread notion that the banks and the LDCs are adversaries. This notion is untrue. We have a common interest in the economic and democratic viability of the LDCs. I myself grew up in Latin America. I speak the language. I know the people and many of their leaders. As a company, Citicorp has been in Latin America for nearly 100 years. We plan to stay there and to grow with these nations. The last thing we want to see is the economies of these countries grinding to a halt. Instead we are anxious to see confidence restored and capital flight reversed.

Right now, negotiations with Mexico are at an extremely sensitive stage. It would be improper for me to discuss any

details. I am confident, however, that we are close to an agreement. Once an agreement with Mexico is completed, we will then be in a better position to assess the Brady Plan and its prospects for dealing with other debtor nations.

Let me add a word of caution. The LDC debt problem is not a problem that is well-suited for a legislative solution. The situation in each of the debtor nations is different and must be approached on a case-by-case basis. Moreover, only a third of the creditor banks are based in the United States, and these banks hold less than 30 percent of the total debt. Nothing is gained by applying pressure only to the U. S. participants in these negotiations. It is certainly not in the interest of the United States to disadvantage its own banks relative to creditor banks in Europe and Japan.

Conclusion.

A major restructuring of our financial system is necessary. Restoring the United States financial system to world-class status is important for the health of the financial services industry. But more importantly, it is crucial for the U.S. economy as a whole. The United States will be unable to maintain its leadership of the world economy without vigorous and healthy financial markets. The decisions made by this committee, and by your colleagues on other important committees in the Congress, will materially determine whether or not the United States continues to be a leader in the world economy going into the 21st century, or whether it sinks into secondary status.

I would be happy to work with Committee members in any appropriate way to achieve these goals.

The CHAIRMAN. Thank you very much. There were a number of provocative thoughts here and we are anxious to get into an exchange.

Mr. Rohatyn, we'd like to hear from you next, please.

STATEMENT OF FELIX G. ROHATYN, SENIOR PARTNER, LAZARD FRERES AND CO., NEW YORK, NY

Mr. ROHATYN. Thank you, Mr. Chairman.

Again, I want to join my colleagues in telling you how pleased I am and flattered I am to participate in these hearings and I will summarize my statement and you have my full statement for the record, Mr. Chairman.

The CHAIRMAN. It will be made a part of the record.

Just to summarize my statement, Mr. Chairman, I would like to—before looking forward, I think you have to look back a little bit and I believe that many of the more serious economic problems facing us today, both domestically and internationally, are the result of financial excesses of the past 10 to 15 years.

EXCESSIVE USE OF CREDIT

These included excessive use of credit, a very highly speculative climate in all our financial markets, and a consistently short-term philosophy on the part of our major institutional shareholders.

I believe the challenge of the 1990's will consist of several major components.

First, to clean up the leftover problems of the 1970's and 1980's, and this includes the S&L's and the Third World debt.

Second, avoid their repetition. This includes tougher regulations as to the massive substitution of debt for equity of the 1980's and the excessive use of speculative financial instruments by federally insured entities. It includes reform of Federal Deposit Insurance.

Third, to support regulation and/or legislation that will strengthen our financial institutions in the face of European and Japanese competition as well as encouraging new investment and discouraging excessive borrowing.

I believe these steps can only be effective if they are taken within the context of putting our domestic financial house in order. This requires taking serious actions to balance the Federal budget over the next three or four years, combined with significant reductions in real interest rates.

Significant worldwide interest rate reductions are probably the most single important action we could take to limit the existing risks to the financial system.

Let me make the following few suggestions for particular consideration of your committee.

On savings and loans, I believe that in order to avoid repetitions of this sorry mess I would hope that the Senate/House conference will maintain very stiff capital requirements for thrifts, disallow goodwill as valid capital, and phase out over the next couple of years the ability of thrifts to invest in below-investment grade securities.

I don't know whether the S&L industry is a viable competitive industry going forward, and if it turns out that it is not, I would very much support it being folded into the commercial banking system.

PETRODOLLAR RECYCLING

Second, commercial banks. Encouraged by their own governments, and under the heading of "petrodollar recycling", the Western banking system engaged in a huge amount of careless lending to Third World borrowers in the 1970's. This lending, which I believe to be a failure both on the part of the banks and their regulators, was compounded by the equal failure of careless and sometimes corrupt borrowers. The Brady plan finally faces the reality of this situation by calling for debt reduction which essentially recognizes that existing loans are only worth a fraction of their carrying values.

The banking system has now started, very aggressively, another cycle of debt in connection with large takeovers and LBO's. As banks, together with investment bankers, become more and more aggressive as to levels of acceptable risk, the risk to the banking system in case of an economic downturn becomes more significant. The capital adequacy of the U.S. banking system should be examined in this light, as well as the capacity of our banks to compete against their much larger foreign competitors.

Third, the securities industry. The securities industry is clearly undercapitalized in light of the levels of risks in its activities. Several major houses could have failed October 19-20, 1987, if the Federal Reserve had not intervened energetically in order to maintain banking support for the securities industry. And I must tell you, Mr. Chairman, that the gentleman sitting to my left I think played as important a role in saving the United States and the world financial system on October 20, 1987 as anybody else, together with his chairman, and I want to pay great tribute to that.

The banks and the investment houses are now both competing over the highly profitable and yet very risky business of takeover credits. More permanent capital should be required of securities houses engaging in this activity.

In other areas or risk, further reform is required. Since October 1987, no real change has occurred and, in activities such as options and futures, margin requirements equivalent to those required on the underlying securities should be imposed. The SEC should be the ultimate regulator with respect to options and futures as well as the underlying securities involved. The Federal Reserve should be the ultimate regulator with respect to capital adequacy of the securities industry.

Fourth, credit-driven speculation. The 1980's witnessed a fantastic surge in credit-driven speculation. This was made possible by a combination of large deficit spending by our own Government, by foreign capital inflows, by financial deregulation, by computer technology creating new financial instruments of all types, by a tax system which favors debt over equity and by the drive for short-term performance of financial institutions. To curb speculation and illegal behavior the following should be considered.

I think laws should be clearer as to what constitutes illegal behavior and quite harsh in its punishment. This includes insider trading, parking, manipulation, and other kinds of illegal behavior.

When the Federal budget allows it, the double tax on dividends should be eliminated.

We should consider reducing capital gains taxes as part of a package that would include presently tax-free institutions such as pension funds. Taxing capital gains of pension funds would reduce their incentive for high portfolio turnover and would also create an economic incentive to encourage tax-free, equity-based mergers as opposed to taxable, high-leveraged, cash takeovers. A sliding scale of tax rates, related to holding period, should be included.

Last, in order to reduce the speculative temptation of poorly financed tender offers, I believe a minimum requirement of 50 percent of firm financing should be imposed on tender offer launches. If a management LBO is involved, the statutory tender offer period should be lengthened possibly to 60 or 90 days.

I would support efforts to amend the Federal Deposit Insurance System to reduce the risk to the taxpayers and to toughen oversight of both the banks and the S&L's.

I believe Glass-Steagall is being dismantled more rapidly by regulation rather than by legislative action by the Congress. Glass-Steagall should be amended but it should be done in the light of worldwide banking and global securities markets. Capital requirements and regulations dealing with all aspects of these issues should be developed concurrently and I would pay particular attention to the conflict of interest problems created by having under one roof the credit function, the advisory function, and the asset management function.

EUROPE 1992

World markets require world class institutions. American banks and other financial institutions seem to be falling behind their Japanese and European competitors in terms of financial power. As the Congress reviews questions of interstate banking and bank mergers, we should keep in mind the need for critical mass.

Unified regulation, both in the securities and the bankings area, will become increasingly important.

Equal rules as to foreign acquisitions. Foreign control of American business is becoming an area of increasing economic and political importance.

American companies, as much as possible, should be put on an equal footing with foreign acquirors when it comes to acquisitions. This suggests a review of tax and accounting matters such as the amortization of goodwill.

Last but not least, an effort must be made to have reciprocal access in terms of investment as well as trade, including access to the acquisition of control, which is not always the case in some foreign countries.

Last, I think the issue of sovereign lending should be reviewed. The foreign policy problems created by Third World lending and the possible need for large-scale credit facilities for Eastern Europe and possibly the Soviet Union require some review of this subject.

Should banks lend to foreign governments or should they limit their activities to project finance and lending to multinational institutions such as the World Bank? Do we need some type of government-supported export credit guarantee system as many European countries have in order to do business in some of these areas? Should the role of the Export-Import Bank be enlarged for such purposes?

I thank the committee for listening to me. I've tried to provide some suggestions about existing problem areas, as well as a possible agenda for future inquiry. The financial world is changing very rapidly and it is clear that a great many geopolitical questions will be dealt with in the economic sphere rather than the military sphere. That is all to the good as long as we maintain our preeminence as the world financial center, protect the integrity of our capital markets as well as the safety of our financial institutions and commit ourselves to long-term productive investment in lieu of short-term speculation.

Thank you, Mr. Chairman.

[The complete prepared statement of Felix G. Rohatyn follows:]

STATEMENT

BY

FELIX G. ROHATYN

SENIOR PARTNER, LAZARD FRERES & CO.

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

JULY 13, 1989

Many of the more serious economic problems facing the U.S. today, both domestically and internationally, are the result of financial excesses of the past 10-15 years. These included excessive use of credit; a highly speculative climate in all financial markets; and a consistently short-term philosophy on the part of our major institutional shareholders. Financial market deregulation, together with huge amounts of deficit spending by the Government, were also important parts of this equation.

The challenge of the 1990s will consist of several major components:

1) Clean up the leftover problems of the 1970s and 1980s. This includes the S&L's and the Third World Debt;

2) Avoid their repetition. This includes tougher regulation as to the massive substitution of debt for equity of the 1980s and the excessive use of speculative financial instruments by federally-insured entities. It includes reform of Federal deposit insurance;

3) Support regulation and legislation that will strengthen our financial institutions in the face of European and Japanese competition, as well as encouraging new investment and penalizing excessive borrowing.

These steps, of course, can only be effective if they are taken within the context of putting our domestic financial house in order. This requires taking serious actions to balance the federal budget over the next three or four years through a combination of new revenues and real cuts, combined with significant reductions in real interest rates. Significant world-wide interest rate reductions, as part of a serious budgetary program, would be the single most important action we could take to limit the existing risks to the financial system. Let me make the following suggestions for the consideration of your Committee:

1) Savings-and-Loans. It is with fascination, not to say astonishment, that we have witnessed a scandal that, over the last few years, has mushroomed to its present magnitude of $200-$250 billion and maybe much more. During this period, everything we were told about this situation turned out to be wrong. The most astonishing aspect of this scandal is the lack of public outrage and the absence of large-scale criminal indictments. The notion that taxpayers will have to pay $250 billion as a result of management incompetence, regulatory failure and outright theft in the tens of billions, and that no one seems to be going to jail is mind boggling.

In order to avoid a repetition of this sorry mess, I would hope that the Senate/House Conference will maintain stiff capital requirements for thrifts, disallow "goodwill" as valid capital, and phase out, over the next two years, the ability of thrifts to invest in below-investment grade securities.

I am not sure that S&L's are a viable business in tomorrow's financial world; that can only be determined if they are required to behave as normal financial institutions and not like riverboat gamblers playing with taxpayers money. If they cannot function on that basis, they should be, over time, folded into the commercial banking system.

2) Commercial Banks. Encouraged by their governments, under the heading of "petrodollar recycling", the Western banking system engaged in a huge amount of careless lending to Third World borrowers in the 1970s. The failure to exercise care on the part of the banks and their regulators was compounded by the equal failure of careless and sometimes corrupt borrowers. The Brady plan finally faces the reality of this situation by calling for debt reduction which essentially recognizes that existing loans are only worth a fraction of their carrying values. The cost to the U.S. Treasury of this series of costly failures will be approximately half of the ultimate write-down. In addition to this direct cost, the debt situation has created, in Latin America, the Philippines, Africa, and now Eastern Europe, profound political problems with significant

foreign policy implications. Their ulimate indirect cost to the U.S. may be many times greater than their direct cost.

The banking system has started, very aggressively, another cycle of debt in connection with large takeovers and LBO's. These transactions are driven by very large front-end fees and the credit is then laid off to other banks, here and abroad. As banks, together with investment bankers, become more and more aggressive as to levels of acceptable leverage, the risk to the banking system in case of an economic downturn become more significant. The capital adequacy of the U.S. banking system should be examined in that light, as well as the capacity of our banks to compete against their much larger foreign competitors.

3) Securities Industry. The securities industry is clearly undercapitalized in light of the levels of risks in its activities. Several major houses could have failed October 19-20, 1987, if the Federal Reserve had not intervened energetically in order to maintain banking support for the Securities industry. Massive positions are carried with questionable hedging techniques. Significant risk arbitrage activities are carried on, hugely profitable in good times, but exceedingly volatile and costly in down markets. The newest and most profitable activity, is the "bridge loan". This is essentially a short-term,

subordinated credit provided to a company in the midst of an acquisition or a leveraged restructuring. Securities' houses have made bridge loans equal to their total net capital, which are financed by the sale of short-term commercial paper at the holding company level. Market conditions may occur under which a bridge loan cannot be refinanced; it is possible that, under those conditions, it may be difficult to roll over the commercial paper. The banks and the investment houses are both competing over this highly profitable, and yet very risky business. More permanent capital should be required of securities' houses engaging in this activity.

In other areas of risk, further reform is required. Since October 1987, no real change has occured and, in activities such as options and futures, margin requirements equivalent to those required on the underlying securities should be imposed. The SEC should be the ultimate regulator with respect to options and futures as well as the underlying securities involved. The Fed should be the ultimate regulator with respect to capital adequacy.

4) Credit-Driven Speculation. The 1980s witnessed a fantastic surge in credit-driven speculation. This was made possible by a combination of huge deficit financing by the U.S. Government, by foreign capital inflows, by financial

deregulation, by computer technology creating new financial instruments of all types, by a tax system which favors debt over equity and by the drive for short-term performance of financial institutions. Many of the new financial instruments provided access to greater leverage: subordinated securities with pay-in-kind provisions for dividends or interest; options and futures on anything and everything with infinitesimal margin requirements etc. The feverish takeover activity generated by this climate encouraged highly aggressive behavior on the part of some members of the financial community, some of it crossing over the line of illegality. To curb speculation and illegal behavior the following should be considered:

a) Laws should be quite clear as to what constitutes illegal behavior and quite harsh in its punishment. Not only insider trading, but also parking, manipulation, failures to make appropriate disclosure etc. have to be more clearly defined, aggressively prosecuted and severely punished. They are inexcusable criminal activities.

b) When the Federal budget allows it, the double tax on dividends should be eliminated.

c) We should consider reducing capital gains taxes as part of a package that would include presently tax-free institutions such as pension funds. Taxing capital gains of

pension funds would reduce their incentive for high portfolio turnover and would also create an economic incentive to encourage tax-free, equity based mergers as opposed to taxable, high-leveraged, cash takeovers. A sliding scale of tax rates, related to holding period should be included.

A revenue-raising alternative to be considered would be a turnover tax on securities which, at the rate of say 1/2%, would raise $10-12 billion p.a. It should apply to all investors, individual or institutional.

d) A minimum requirement of 50% firm financing should be imposed on tender offer launches. If a management LBO is involved, the statutory tender offer period should be lengthened to 60-90 days.

5) Amend Federal Deposit Insurance. This is a high priority issue that must be tackled soon. The whole system of insurance as it relates to banks and S&L's must be reviewed and amended together with the oversight that goes with it. This has to include holding company issues, brokered deposits, investment restrictions and many others. The recent rash of bank failures, together with the S&L fiasco, are not only due to weak energy and real estate markets, but to deeper structural weaknesses.

6) Glass Steagall. The Glass-Stegall Act is being dismantled by the regulatory actions of the Fed rather than legislative action of the Congress. Glass-Steagall should be amended but it should be done in the light of world-wide banking and global securities markets. Capital requirements and regulations dealing with all aspects of these developments should be developed concurrently.

As banks and securities' houses encroach more and more on each other's activities, the conflicts-of-interest created in many of these overlapping roles should be considered. We now find, under one roof, the corporate advisory function; the credit function (bridge loans or bank loans); and the underwriting function. Consideration should be given about separating the advisory functions from the capital raising functions. It should also be recognized that junk bonds are not so far removed from equity securities; whether it is appropriate for banks to underwrite these securities should be the subject of considerable review.

7) Europe 1992. World markets require world class institutions. American banks and other financial institutions seem to be falling behind their Japanese and European competitors in terms of financial power. As the Congress reviews questions of interstate banking and bank mergers, we should keep in mind the need for critical mass.

Unified regulation, both in the Securities and the banking area, will become increasingly important. Clear responsibility of lender-of-last resort should also be reviewed in the case of multinational banks operating in tax havens.

8) Equal Rules as to Foreign Acquisitions. Foreign control of American business is becoming an area of increasing economic and political importance. Some clarification is called for as to those areas where restrictions on foreign ownership presently exit. Does banking include large securities houses? Does broadcasting include cable TV? Does defense include high-technology areas such as data processing or telecommunications?

American companies, as much as possible should be on an equal footing with foreign acquirors when it comes to acquisitions. This suggests review of tax and accounting matters such as amortization of goodwill.

Last, but not least, an effort must be made to have reciprocal access in terms of investment as well as trade. We must have the freedom to invest in Japan and Europe as freely as we allow investment in this country, including the purchase of corporate control. This is not presently the case.

9) Sovereign Lending. The foreign policy problems created by the Third World lending activities of the commercial banks and the possible need for large-scale credit facilities for Eastern Europe and possibly the Soviet Union require some review of this subject. Should banks lend to foreign governments or should they limit their activities to project finance and lending to multinational institutions such as the World Bank? Do we need some type of government-supported export credit guarantee system as many European countries have in order to do business in some of these areas? Should the role of the Export-Import Bank be enlarged for such purposes?

I have tried to provide the committee with some suggestions about existing problem areas as well as a possible agenda for future inquiry. The financial world is changing very rapidly and it is clear that a great many geopolitical questions will be dealt with in the economic sphere rather than the military sphere. That is all to the good as long as we maintain our preeminence as the world financial center, protect the integrity of our capital markets as well as the safety of our financial institutions and commit ourselves to long-term productive investment in lieu of short-term speculation.

Senator GARN. Thank you, Mr. Rohatyn.

Mr. LIGHT.

STATEMENT OF JAY O. LIGHT, THE GEORGE F. BAKER, JR. PROFESSOR OF BUSINESS ADMINISTRATION AND SENIOR ASSOCIATE DEAN, HARVARD BUSINESS SCHOOL

Mr. LIGHT. Thank you, Mr. Chairman.

I'm pleased to be here and, as have the other guests, have written a statement which I would like to have included in the record. I will keep my current comments brief and try to summarize some of the more salient issues as I see them.

I think if one stands back and asks what's really going on and what's really driving the very high rate of change we see today in the financial system, there are really four things.

The first and in many ways most obvious is globalization, both of our markets, of our institutions, and of our dependence upon the rest of the world for our financing.

Another is the rise in debt, the government debt, corporate debt, household debt, or really all kinds of debt. And both of those have been chronicled both by the earlier speakers and I think by many others over the last several years.

But there are two other things that are going on that in my view are at least as important and may be even more important in terms of driving the long-run structure of the system.

One of these is the securitization of the debt markets. The debt markets, as we all know, are becoming less and less private intermediated markets and more and more publicly traded markets. The basic character of those markets is changing very rapidly and it has changed in a dramatic way the prospective profitability of a number of intermediary functions.

The fourth is quite different from that. It occurs in the equity markets and what's going on there, I believe, is exactly the opposite. It's the privatization of the equity markets, changing them to a form which is quite different from what we have historically considered them to be. It was not so long ago that we thought of the notion of equity ownership as consisting of a very large number of small shareholders, be they individuals or institutions, as the shareholder base of a major company.

It is quite clear in supplementing that—and in many cases changing that—is a vastly enlarged set of private markets for businesses, for large segments of companies, and in the extreme—in the case of LBO's—for entire companies themselves.

And most of what we see driving the profitability of institutions, driving the business strategy of institutions and driving the evolution of the financial system today we can lay at the feet of those two trends: the securitization of debt markets and the privatization of equity markets, as they become much more like each other in terms of the characteristics of the financial transactions.

Well, what are the implications of all this? The first implication and, I think, in many ways the most important implication is the substantial increase in systemic risk—you might call it fragility, you might call it a number of different things—but it stems from a whole variety of trends, all of which are headed in the same direction.

MORE DEBT AND LESS EQUITY

We've got more debt and less equity at the borrower level. We've got more debt and less equity at the lender level. We've securitized markets in a way that if economic troubles hit, it will be more difficult for a vast array of holders of securities in the secondary market to recontract and renegotiate in a way that ultimate economic value is saved than it would have been had we gone through intermediaries.

Finally, we are more hostage to foreign investors for a variety of dollar-denominated lending than we ever were before. Thus, not only are we more fragile or more prone to the kinds of risk that leverage can exacerbate on the one hand, but both our private maneuvering room and our public maneuvering room is vastly curtailed. So it is that in some sense, in a rather complicated sense, the systemic risks are increasing and continue to increase with each passing year.

At the same time, it's quite clear that the profitability of virtually every intermediary function has changed in a dramatic way. Some have become much less profitable. Some have become much more profitable. And all are, of course, subject to a vastly increasing and different set of competitive factors as we become more global.

So it is at the same time that risks are increasing dramatically, the business strategies of virtually every major set of players within the financial system is changing in an important way.

I would associate myself with a number of the different—indeed most of—the recommendations that we've heard this morning from the three earlier speakers. I might put a somewhat different set of priorities and a somewhat different spin on some of those though, so let me go through a list of the priorities as I would see them.

At the heart of the problem and at the top of the list of my priorities would be equity capital within a broad array of financial intermediaries. That would apply to thrifts. That would apply to commercial banks. That would apply to securities firms.

It's quite clear to me that in each of those cases the actual equity needs to be larger. It's quite clear that the accounting rules used to generate estimates of equity capital need to be tougher, and I think it's quite clear that we need to continue to evolve to a more risk-based set of capital notions. In particular, we might well use notions of supplementary capital requirements for particular kinds of business as a way of dealing with a variety of the issues that are arising and will continue to arise over the next decade.

It's quite clear that tougher capital standards will be difficult for some individual firms. It will be difficult for a vast array of thrift institutions. It will be difficult for an array of banking institutions. It is also quite clear to me, though, that if we do nothing about that this very basic building block, we will, in fact, have socialized the intermediary risks of our system in the end, whether we chose to or not.

So no matter what else we do, I believe that capital should be the beginning point of thinking about the evolution of the financial system and we should take some risks as to lack of competitiveness if need be in order to make sure we've got that one right or at least righter than we now have it.

LET WELL-CAPITALIZED THRIFTS ENGAGE IN DIFFERENT LENDING BUSINESSES

Second, it seems to me at least in the case of well-capitalized financial intermediaries we should at least allow and in many cases encourage them to evolve along lines that may be quite different than what was their historical focus. It seems to me, for example, that well-capitalized thrifts ought to be allowed to engage in a variety of different lending businesses, some of them much more like the kind of lending businesses undertaken by banks and perhaps securities firms.

It seems to me also clear that banking institutions ought to be allowed to evolve into a number of businesses that have heretofor been known primarily as the businesses of the investment banking community and that Glass-Steagall prohibitions should be allowed to evolve along a variety of sensible paths. It also seems clear to me that some of the clear changes occurring in the field of securities firms themselves should be allowed to continue.

Now all of these will perforce curtail and reduce the distinctiveness amongst different kinds of financial institutions, but I think that's a small price to pay. In the modern world, I think that that historical distinctiveness has less advantages for us than others might think.

On the other hand, I think that this kind of evolution should only be allowed not as the right of all firms but as the privilege of well-capitalized firms and used as the incentive for financial institutions to build up their equity capital.

Second, clearly insofar as the functions are vastly different than those that have been pursued in the base business, they should take place through a holding company quite different than the narrow institution that forms the historical base of the larger conglomerate. And finally, they should take place in a way that the risks to the taxpayers of socializing the risks of that diversification are minimized, if not completely curtailed.

In short, we should allow and encourage the evolution of a very different kind of a system for those entrants that are well-capitalized and not for others.

There are a variety of other concerns that come to mind as one looks at what's going on across the financial system. I might touch on three.

What do we do about this problem of too much debt? Or what do we do about the problem of too many highly leveraged entities? Or what do we do about the problem of too many deals where you can substitute whatever particular form of debt seems at the moment to play the important role in the front pages of the Wall Street Journal?

My own view is that these problems are not imminent short-run dangers. On the other hand, it seems to me that the proper focus of public policy at the current juncture would be to lean against these winds in order to try to encourage in the longer run or at least not discourage sounder capital structures throughout the vast bulk of American industry.

Most of what has to be done there seems to me to fall within the purview of the tax code; and in particular the tax code now very clearly encourages extreme forms of leverage and discourages—indeed charges a rather large penalty—for sound capital structures. That clearly should be changed. The easiest way to change it is the expensive way to change it, which is doing away with the double taxation of dividends. And when and if that's possible, that should surely be done. In the meantime, some partial steps in that direction would be important ones to take.

Also, it seems to me in terms of the tax structure, extreme forms of debt that in fact are equity in disguise should be changed in terms of their tax treatment. Also, it seems to me that supplementary capital requirements should be imposed on institutions that buy and hold such securities for their portfolios.

As to the larger issue of whether we are discouraging long-run investment; that's very unclear in my own view. The remedies there, should we seek remedies, are perhaps two-fold. One is higher short-term capital gains rates and lower long-term capital gains rates, and that's the easy part of the problem. The much harder part of the problem would be changing the form of corporate governance in a way that the very large accumulations of equity capital now residing in pension funds and other large institutions have an incentive to play the role of long-term participants in the corporate governance process, something they do not do today. That really would be a profound change in the way we go about the process of governing companies. I think taking some small steps in that direction would be an important direction to consider.

Thank you very much.

[The complete prepared statement of Jay O. Light follows:]

FINANCIAL TRENDS AND THE CURRENT PRIORITIES FOR PUBLIC POLICY

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Statement Before the Senate Banking Committee
July 13, 1989

SUMMARY

The U.S. financial system is now being rapidly transformed by four dominant trends: the globalization of financial markets and intermediaries, the securitization of debt markets, the privatization of equity markets, and the substitution of debt for equity in capital structures. These trends will almost surely continue well into the 1990s and transform our financial system as we now know it. Moreover, these changes are occurring in the context of disturbingly imbalanced economic growth, in the sense of both trade and budget imbalances.

The implications of these trends are both troublesome, on the one hand, and hopeful on the other. Most obviously, the systemic risks and exposure of our financial system to unexpected shocks has clearly and materially increased. Greater debt, intermediaries weakened by problem assets and slim capital cushions, greater reliance on securitized debt instead of intermediaries, and a greater reliance on the rest of the world to fund our debt all imply a more fragile financial system than we have had or would like to have. These same trends have dramatically altered the profitability of various financial service businesses. By so doing, they have altered the business strategies of financial firms, and now constitute an inexorable pressure toward substantial and necessary changes in the structure of our financial industries.

There are a variety of important public policy responses that seem appropriate. While tax policy will not be discussed in detail here, it is clear that narrowing the twin deficits, the federal budget and the trade deficit, would be an important improvement in the general economic background within which the financial system functions. The equity capital cushions of several important financial institutions, particularly the deposit institutions, should be rebuilt; and where possible, capital requirements should be individually based upon the risks undertaken by each institution. The evolution of those institutions toward broader-based intermediaries, that serve a variety of new and sometimes riskier functions, should proceed. And this evolution should include the continuing erosion of Glass-Steagall. This diversification of function should occur, however, only as the earned privilege of well-capitalized and well-managed institutions, only through their holding company vehicles, and only in a way that it is unlikely that U.S. taxpayers will bear the downside of failed diversification.

While there is probably no clear and imminent short-run danger from increased corporate debt burdens, public policy should nonetheless attempt to lean against this wind because of its contribution to our increased long-run fragility. The Tax Code and government regulatory agencies should adopt a variety of policies which discourage, or at least don't encourage, extreme forms of leverage. The SEC should encourage the evolution of new corporate governance processes through which large pools of capital can be more active but more permanent long-term investors. Finally, the various government agencies should co-ordinate their efforts to form an integrated, responsive, global surveillance system to monitor financial market events in real time and formulate timely governmental responses to unexpected financial shocks.

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to present my views on the looming challenges and problems facing the financial sevice community.

The U.S. financial system is now being rapidly transformed by four dominant trends: the globalization of financial markets and intermediaries, the securitization of debt markets, the privatization of equity markets, and the substitution of debt for equity in capital structures. These trends will almost surely continue well into the 1990s and transform our financial system as we now know it. Moreover, these changes are occurring in the context of disturbingly imbalanced economic growth, in the sense of both trade and budget imbalances. Sensible overall government policies ought to deal, as a first priority, with the two economic imbalances. In terms of government policies specifically directed toward the financial system, however, we should not necessarily strive to arrest the ongoing changes or turn the clock back to an earlier simpler time. Rather, the government's primary role should be to enhance and evolve the system of safety buffers and restrictions designed to maintain the public's confidence and to insulate the public interest from adverse and unexpected financial events. This may well be a more difficult task than it has been for several decades.

The Four Trends

First, and most obviously, the U.S. financial system has become much more integrated with others around the world. Instantaneous global telecommunications and heightened international competition among financial intermediaries have led the way toward greater linkages among hitherto independent financial systems. While financial markets (with the possible exception of some government debt markets, like our own) are not yet truly global, the influences on them surely are. Moreover, the U.S. has an increasingly worrisome special problem in this regard, as our trade imbalances have and will continue to transform us into the world's largest debtor. We have already sacrificed a good deal of our ability to independently determine our economic policy and destiny. While thus far our lost independence has not been especially troublesome, we have yet to understand and appreciate what the implications might be in a time of future crisis.

Secondly, virtually all of the U.S. debt markets, and many of the rest of the world, are becoming rapidly securitised. Up until quite recently, virtually all flows of new debt (other than high quality Treasury debt) were intermediated in the sense that a financial intermediary held the privately-negotiated and only rarely traded debt contracts, and issued an equivalent amount of higher quality obligations (for example, deposits) to the ultimate savers. Banks, thrifts, and insurance companies played the most important roles in this system of intermediaries. Today, however, the net new flows of debt are comprised primarily of publicly-traded securities which may be originated by some credit-granting institution, but very shortly thereafter become relatively liquid 'securities' which can be bought and sold in the secondary markets. Mortgage-backed securities, for example, have become the most important segment of the U.S. mortgage markets. Euro-notes have replaced syndicated Euro-dollar loans for higher quality international borrowers. Commercial paper has supplanted short-term corporate borrowings from banks. High-yield (or junk) bonds have replaced private placements as the mainstay of the lower quality corporate credit market. Etc. While the details of each of these transformations vary from market to market, the common features are that private credit transactions that used to take place entirely within a highly regulated intermediary have been replaced by more open market processes with more standardized publicly tradable contracts and substantial numbers of potential investors.

At the same time that our debt markets have become more securitised, equity markets have been evolving in the opposite direction. In particular, we have recently been witnessing the privatization of common stock ownership. Not so very long ago, the typical shareholders of corporations were a vast array of individual shareholders and institutions, almost all of whom held the stock in diversified portfolios, passively accepted the corporate policies of management, never voted their shares against management or managements' recommendations, and merely traded their shares (with varying turnover rates) in search of incremental returns. But recently, individual investors have been liquidating their shares at an unprecedented rate. Last year alone, individuals were net sellers of almost 8% of the common shares that they had held either directly or indirectly (through mutual funds) at the beginning of the year. And some of the largest institutional funds, including both pension funds and endowments, have begun participating in private pools of capital which take significant privately-negotiated illiquid positions in corporate equity. Today, the equity ownership of even very large corporations is changing dramatically to include LBO pools, strategic block investors, sizeable holdings by known or suspected corporate 'raiders', or known or suspected friendly 'knights', or ESOPs, and/or managers themselves, all of whom have a very different relationship to the company than its earlier quite passive public investors. Moreover, active 'private markets' have developed where corporate assets and often whole divisions of corporations are bought and sold. The RJR-Nabisco privatization of late last year is perhaps the most dramatic example of such trends, but it just typifies what is proceeding at a very broad and rapid pace. From a longer-run perspective, we may well be evolving relatively rapidly toward a system of equity ownership much more like that of other industrialized countries where a substantial fraction of our corporate equity is held in 'private positions' that exert an influence on and, in the extreme, exert absolute control over corporate management and its policies. And broad public ownership by a myriad of individual investors is becoming far less important, both in terms of its percentage ownership and in terms of how corporations are managed and controlled. The individual investors of the future are becoming the free-riders on the coattails of a small number of large private equity investors, rather than the central feature of equity markets.

Finally, and in part because of the aforementioned changes, there is a dramatic change underway in the typical capital structure of American corporations, away from equity and toward debt. Indeed, during the 1980s, debt of all kinds grew very rapidly indeed. The federal government utilized Treasury debt to fund its budget imbalances and off-budget Federal Agency debt to fund its further imbalances, households utilized debt to fund their increased consumption, and corporations utilized debt to transform and restructure their balance sheets, particularly during actual or threatened management control changes. All this has been chronicled in detail elsewhere. Suffice it to say for our purposes here that the debt build-up has been and is being driven by a variety of important factors, only one of which is the tax advantages of debt. The increasingly frenetic market for corporate control in the U.S., the changed structure of equity investors and attitudes of large institutional investors, and the relatively abundant availability of securitized high-yield debt have been more responsible for the changes we now see. These four trends, (globalization, the securitization of debt, the privatization of equity, and the trend toward more debt) are all mutually consistent and re-inforcing dimensions of change within our financial system.

Implications

There are many implications of these trends, and only those most important from a public policy perspective will be discussed here. First, and perhaps most obviously, the systemic risks in our financial system have clearly increased. Greater debt of all kinds, and particularly household and corporate debt, has increased the risks for the specific borrowers and for all of us. One can quibble about just how highly leveraged we are relative to other industrialized countries, but there is no question that we are more highly leveraged now than we used to be. Compounding this difficulty is the concern that many of our financial institutions, particularly our thrifts and some banks, also have too little equity capital, particularly if assets are valued at their market value as would be appropriate for truly assessing our systemic risks. Thus, there is surely less of an equity cushion at the borrower's level and less of an equity cushion at the lender's level. In addition, because much of our lower credit quality has been securitized, for example "junk bonds", the recontracting and renegotiation processes that are generally triggered by unexpected adversity may be increasingly difficult to manage. One of the great public policy advantages of channeling most borrowing through financial intermediaries had been that when a loan or loans went sour, the intermediary could attempt to smoothly recontract with the troubled borrower(s) in the hopes of preserving as much real economic value as

possible from the underlying businesses and assets. Also, because financial intermediaries are in principle highly-regulated institutions, the objectives of public policy could be implemented through them. Open markets have neither of these advantages. When many investors hold securities in default, it is much more difficult to recontract and much more difficult for both private parties and for the government to isolate and manage financial problems. The stability of our newer high yield securities markets is still very much untested.

There is a final reason why our financial risks have increased. Because so much of our debt is now held abroad, the dimensions along which the Federal Reserve, Treasury, or other government agencies have the ability to respond to future crises may turn out to be substantially curtailed. Pursuing purely domestic objectives becomes less and less possible as foreign debt mounts, and this particularly includes the ability to respond in crises.

The conjunction of all these developments clearly means that we are living in a more fragile financial world, more fragile than it has been for some time, and more fragile than we would like it to be. It is probably true that the future events that could trigger a potential financial crisis are not risks we are now contemplating. The trigger(s) more likely will come from completely unexpected directions. The worrisome feature of our current circumstance is that we have thinner safety buffers and probably less room to maneuver than we think we have, and certainly less than we might like to have.

The four major trends have also changed, in a dramatic way, the actual and potential rewards available in the financial services sector. The securitization of debt markets has driven down the spreads obtainable from intermediated lending, at least for high quality credits. And competition from foreign intermediaries has also tended to narrow spreads, particularly in the corporate debt markets. American financial intermediaries have had no choice other than to themselves settle for razor thin margins, at least by historical standards, for high-quality credits. The good news is that our debt markets are thus more efficient and can provide low cost capital to a variety of borrowers. The bad news is that our domestic intermediaries have great difficulty earning an adequate spread in their traditional high quality lending businesses.

In the case of the mortgage markets, for example, the conjunction of many different federal insurance, guarantee, and intermediation programs gave rise to the mortgage-backed securities market. For consumers, of course, this was a helpful innovation, for it reduced the effective costs of financing their homes. And for lenders like thrifts, the securitized market also had its advantages, for it made their portfolios of home mortgages more liquid. But such federally-sponsored programs can also merely sow the seeds of future problems for private intermediaries. Ultimately, in this case, the securitized mortgage markets dramatically reduced the profitability of the home lending business, making competitive survival and success quite difficult for the thrift institutions that depended upon it. When deregulation (without adequate supervision) came along in the 1980s, the stage had already been set for institutions to reach for greater profit margins and up-front fees in new and risky lending businesses.

An analogous situation has occurred in corporate lending. Competition from the commercial paper market, the unregulated Euro-markets, and the domestic (U.S.) lending of foreign banks and/or their subsidiaries has dramatically narrowed spreads for high quality corporate lending. One of the 'remedies' for the banks has been higher risk lending, which has generated substantial fees and greater profit margins. Similarly, insurance companies had managed to drive up their cost of funds in the guaranteed contract (GIC) business at the same time that the growth of the high yield bond market held down lending rates. The conjunction of these two effects meant that their traditional lending activities had great difficulty providing an adequate spread. Again, this created an inexorable tension to reach for higher risk lending opportunities.

The privatization of equity markets has also changed dramatically the returns available in some financial service segments. Retail brokerage has become a very difficult business, where few firms can really generate adequate returns. Institutional brokerage is not much better, as competition has driven commission rates to levels where profit margins are perilously thin if they exist at all. The profits of Wall Street in recent years have really come from only two incredibly large and lucrative sources: the mergers, acquisitions, and takeover business and the closely-related merchant banking business. In the first business, the mega-fees associated with mega-deals have become the real engine of Wall Street profitability. And a number of firms have extended these ideas to become the actual principals in the privatization of American companies, using their own capital to buy and hold significant private interests in what used to be publicly-held firms. Clearly this second business, the so-called merchant banking business, is substantially more risky than the traditional businesses of Wall Street. But the rather spectacular profits earned there have attracted more and more would-be players from among the firms whose margins in their traditional business have atrophied.

As the profile of returns across businesses has changed dramatically, so too have the business strategies of important financial intermediaries. Thrifts have wanted to become mortgage bankers, real estate development lenders and corporate lenders. Banks have wanted to become investment banks, complete with underwriting and mergers and acquisition capability. And investment banks have wanted to become merchant banks, participating directly in the hoped-for capital gains available from privatizing and/or restructuring U.S. companies. In theory, of course, this is all to the good; it is exactly how a competitive system should work. If these were manufacturing businesses there would be no reasons for concern or alarm, as we would merely see a sensible and appropriate re-alignment of an industry, or really industries, in the face of strategic developments. But these are not just any businesses; they are businesses thought to be more important to the general public interest. At one level, risks that are appropriate to each and every firm might still aggregate to unacceptable risks for the system as a whole. And perhaps more importantly, to the extent that government promises, explicit or implicit, stand behind the ability of a financial services firm to marshal resources, there is a clear danger that

taxpayers will realize the downside, and entrepreneurs the uspide, of any risky new activities.

Public Policy Priorities

Against this background, there are a number of priorities which should be addressed by public policy. Closing the twin deficits of the federal budget and the trade balance are certainly important objectives from an overall economic perspective, as well as from the perspective of the financial system. They are, to a large extent, problems made in Washington which must be solved in Washington.

As regards the financial system itself, the most important general objective should be to rebuild the safety buffers which can help isolate individual problems and insulate the system itself from general crises. Of these possible safety buffers, the capital and liquidity of financial service organizations should be high on our list of priorities. With regard to thrift institutions, for example, rebuilding capital must be one of the pillars of an effective resolution of our current dilemmas. Similarly, rebuilding capital should be a priority for banks and bank holding companies, though in this case an international approach is clearly essential. Much has been addressed in recent years in this regard, particularly in terms of agreeing on common goals, but much remains to be actually achieved. It would also be appropriate, as the business of Wall Street changes so dramatically, to take a hard look at required capital for securities firms. In each of these sectors, it will be important to introduce risk-based capital concepts, wherein a firm must satisfy some minimum capital constraints, but upon adopting a more risky asset structure, the firm's capital requirements should be commensurately increased. It will be important not to let fears of various possible competitive developments deflect us too far from these important equity capital goals. Without substantial attention paid to the rebuilding of equity capital, many of the other changes discussed here would be very troublesome indeed.

With regard to the changes now proceeding in financial service organizations, it would seem wise to let the evolution proceed where its risks are manageable. Well-managed thrift institutions should be allowed to play a larger role, if they choose, in various lending markets. If that continues to blur even further the once distinctive roles of thrifts and banks, so be it. I see no great current advantage to those earlier distinctive roles. The differences between deposit institutions and investment banks are more serious, for here there are clear differences in the extent to which implicit government promises are an essential part of the firms' ability to fund themselves. Moreover, our large commercial banks are the very heart of our financial system, and as such, they play a special role in the system by which confidence must be maintained in the entire system. Nonetheless, because of the great changes in the pattern of returns available in their core business and because of the clear need to compete with foreign institutions with a far broader scope, we should allow some meaningful evolution in the roles played by our commercial banks.

Glass-Steagall should be loosened over time to allow greater participation by banks in securities underwriting and other functions of the securities industry. However, where such activities are a significant departure from the core mission of deposit institutions, they should be undertaken only through subsidiaries of a holding company. And they should be permitted only when the institution is judged by regulatory authorities to be particularly well-capitalized, both in terms of the base institution and its holding company. Furthermore, when government insurance or guarantees are involved, it should be made clear that the explicit and implicit guarantees apply only to deposits (and possibly other closely related liabilities) of the base institution and not to the holding company or its other subsidiaries (this, almost surely, is not the case today). In short, financial evolution should be allowed to proceed along the dimensions that competitive realities (particularly, international competitive realities) suggest, but the evolution should be the privilege enjoyed by well-capitalized institutions who manage that evolution in a careful and sensible way. Importantly, the risks inherent in that evolution should be borne by the managers and shareholders of the parent enterprise and not by U.S. taxpayers.

As regards the leveraging of corporate America, I see no reason to think that the general dangers here are imminent, though there will surely be more individual bankruptcies in the next recession. Nonetheless, a sensible public policy should attempt to lean against this wind, for it does contribute to our overall financial fragility. In any event, public policy should surely not promote extreme leverage, as tax policy now does. Clearly, the single best response of public policy to these long-run concerns would be to end the double taxation of dividends, thereby removing the large tax penalty paid by corporations with a more conservative capital structure. I do appreciate, though, that such a change in tax policy is not necessarily the direct responsibility of this committee nor will it be easy in our current budget deficit position. In terms of other responses, the capital requirements of thrifts should be dependent upon the amount of high yield lending (junk bonds or other high risk debt) in which they engage. And, in any event, there should be a ceiling on the high risk assets that are effectively insured by governmental deposit insurance. A similar though tactically different approach would also make sense for commercial banks, particularly as regards the loans that enable very highly-leveraged take-overs or corporate restructurings. A clear target would be the loans to highly-leveraged situations where the perspective cash flow does not cover the fully-considered financing costs. The regulators of deposit institutions should be encouraged to pursue these policies as regards high-risk lending practices, but be given substantial flexibility to 'write the rules as they go'. Financial entrepreneurs would quickly find ways to circumvent any known and fixed set of precise rules; so that a more flexible, dynamic and perhaps somewhat ambiguous set of guidelines would seem preferable.

The Tax Code and SEC policies should also be changing in ways to encourage the evolution of long-term investing and effective corporate governance procedures. Sliding scale capital gains taxes (perhaps for all investors including large tax-exempt institutions) should be adopted which range from very high rates on short-term holdings to no tax on very long

term holdings. Corporate governance procedures including access to the proxy statement and the relationship between outside directors, management, and large investors with significant holdings, should evolve in a way that large investors are encouraged to take a more active role in determining and ratifying corporate policies. Basically, as the equity ownership of American companies accumulates in large tax-exempt pools of capital, these investors should be encouraged to become active long-term owners rather than frenetic short-term traders of their common shareholdings.

Finally, we need to develop a more active integrated and responsive set of market surveillance processes within our various government agencies. Today, the responsibility for monitoring the fast-changing developments in our financial markets is divided and disjointly pursued by the Federal Reserve, the Treasury, the SEC, the CFTC, and other agencies. The market crash of 1987 highlighted the need for alert, integrated, and international market surveillance of and responses to unexpected events. These would and should provide an important part of the safety procedures for isolating and dealing with specific individual financial problems before their more dire implications become widespread. In a world where private information, communication, investment decisions, and price impacts have become quick, global, and integrated, our regulatory responses need to become the same.

The **Chairman**. Gentlemen, I thank all of you. I've had to go in and out of the room on two or three occasions because we are getting set to go back in on the savings and loan conference at 2 o'clock and there are a lot of items that have to be worked into place and so it's one of these times where you have to be in two places at once.

I want to raise one question and I will not use all of my time because I'm going to yield to Senator Dodd. Senator Dodd, I'm going to just raise one question and I'm going to yield the balance of my time to you for the first round and then go to Senator Garn.

Let me ask you, Mr. Reed, here we sit—I like a lot of what you say. It makes sense to me in terms of the efficiency and certainly you're out in the global market as much as anybody and you understand the kinds of adjustments that need to be made. I'm going into a conference at two o'clock this afternoon because the savings and loan system blew apart for multiple reasons, but it's clearly an epic financial catastrophe at a $275 billion cost at a minimum over the next 30 years and it may be higher than that.

INSURED DEPOSIT PROBLEM

And it's an insured deposit problem. I don't ever want to see another one of these again and no thoughtful person does. But anything that acts in a way to move in a direction of testing the safety and soundness of insured funds I've got great sensitivity in that area. I have quite a different view about risk capital where the Government is not standing in there with the taxpayer behind it providing the insurance.

You've addressed that in part with your idea about not providing complete insurance and maybe creating a different kind of a better informed saver who will shop around a little more carefully and so forth.

But I'm wondering how do we go to the kind of much more wide open system—much of the same argument we heard back in the early days on the savings and loan changes—and still assure ourselves that we're not going to get tipped upsidedown by some set of economic forces that cause another huge financial collapse again, say, in the commercial banking system?

Mr. **Reed**. Senator, it's clear that none of us can devise a system that will prevent all potential problems. It is simply not possible to come up with an architecture that has zero probability of any kind of difficulty.

My own recommendations were designed to prevent problems of the dimension that you have just described from reoccurring—problems which are clearly more than a couple of individual instances of difficulty.

I suggest that we must rely first on a more diversified industry base. If savings and loan institutions had been given the opportunity to participate more fully in the financial system, they would not have had the same incentive to take the interest rate bets which ultimately proved to be their ruin. In other words, I believe if they had had a more broadly based business outlook, they may have been able to avoid a narrow concentration of risk.

The **CHAIRMAN**. Can I just say on that point, because this goes right to the heart of what I'm trying to get at, when we changed the savings and loan ground rules, first at the Federal level in the early 1980's and then at the State levels, it was precisely for that reason. The savings and loan people said, "Look, you haven't given us a broad enough set of business options and we need to get into direct investment in real estate and we need to get into all kinds of different things," so we really broadened it out. In fact, in response to that very same argument, we created a much more unstructured game. That's certainly been part of the problem.

Mr. **REED**. And I'm suggesting that you integrate them into the commercial banking business more broadly. It is fair to say that the commercial banks, when confronting some of the same economic circumstances as the savings and loans, chose to evolve somewhat differently so that there wasn't quite the concentration of problems. If S&L had been permitted to operate more like commercial banks, many problems could have been avoided.

Equally important for the integrity of the financial system, however, is deposit insurance reform. I believe very strongly that the American people expect the Government to absorb some, perhaps most, of the risk associated with placing a reasonable amount of savings in a depository institution.

But I also believe that we could count upon the wisdom of the people, if they knew that they had a 10-percent risk, to discipline the management practices of financial institutions. If you are running an institution, you develop a great sensitivity to the opinion of the depositor. That discipline creates an environment that reduces the likelihood of the kind of problem that you made reference to before. I call to your attention to the fact that in England savings are not 100 percent insured even for small savers

So I think the combination of merging the S&L industry with an industry that has a somewhat broader base and a different tradition—an industry that is appropriately supervised and appropriately capitalized, plus relying on savers to help discipline financial institutions to some degree, is a better structure for solving this problem than the current one.

The **CHAIRMAN**. My time is up. Let me yield to Senator Kassebaum, who is next in the order in terms of arrival here.

Senator **KASSEBAUM**. Thank you, Mr. Chairman.

I would like to just ask some generic questions of anybody that could answer.

TAKEOVER ACTIVITY AND ACCUMULATED DEBT

One, do any of you share some concerns about the takeover activity and the debt that's been accumulated because of that and the influence on our productivity? That doesn't mean that I necessarily think we should get involved in a legislative way to correct this, but is this a problem? Has it had an effect on our productivity and should we be doing anything about it? Anybody? Or maybe it doesn't concern any of you.

Mr. **ROHATYN**. It concerns me a lot. I make my living doing mergers, Senator, and at the same time I am concerned about the structure of a lot of these transactions over the past few years because they are more and more based on credit and less and less based on equity and some of the things we've seen recently make it obvious that it's more and more difficult to do mergers based on straight equity swaps because of interference from credit-driven transactions.

I think that is due to a variety of factors. One is the fact that credit is very easily available. Second, that these transactions are driven by very large fees. Third, that the financial institutions are willing to buy speculative credit instruments like junk bonds in very large amounts. And last, technically they are now feasible, which was much more difficult to do before financial deregulation went as far as it did.

I think the evidence with respect to productivity is not in yet because these are fairly long haul kinds of cycles that you're going to be looking at. As I said in my testimony, I am much more concerned with the potential impact on the stability of financial institutions, including my own industry.

If I were to guess, I would find it difficult not to conclude that over the long haul it would be detrimental to productivity because in effect what you're doing is running more and more businesses in sort of a liquidation mode in terms of running them for cash flow and debt repayment instead of running them for new investment and longer-range profiles.

But as I said, I believe that a lot of the studies are not conclusive at this point. You will hear arguments from very learned academics on all sides of this question, depending whose firm they are acting as a consultant for, and so I think only time will tell.

Senator KASSEBAUM. And part of it is the short-term philosophy that many of you talked about to a certain extent and the desire for the large pension funds and for every investor I suppose to look to the ability to gain the best deal possible where they're going to place their investment and in the quickest turnover time.

I think some of you have suggested some steps. Mr. Light, you said there were some small steps that could be taken to encourage longer-term investment. What small steps?

Mr. LIGHT. Well, I was referring to the corporate governance process there and in particular things like allowing large shareholders greater access to the proxy mechanism and allowing them a more active involvement at the level of the board in terms of charting the basic strategy of the company as well as perhaps allowing them a greater interaction in the process of how the company thinks about and chooses outside directors. Those are three things that might be done to try to encourage them to think of themselves as very long-term participatory investors who are in there over the decades rather than for the next two months. Those things are hard to do and it is hard to know how successful one could be in encouraging that kind of lengthened time horizon, but that would be I think a direction that we should consider.

Mr. ROHATYN. I would disagree with that, Senator. I think institutional investors are still driven by short-run characteristics and their presence on a corporate board would simply push the management into taking more short-range actions than they would take under the present structure. That's a personal view. I sit on a number of boards and so does John Reed and I'd be curious about his opinion.

Mr. **Reed**. I would share the same concern. I do think, however, Senator, you are on to the fundamental point.

The biggest driving force for change is the large pools—very large, internationally speaking—of professionally managed investment money. The current structure of finance, as we witness it in these transactions, reflect the values of the managers of these pools. It's their willingness to hold risky debt that causes risky debt to be used in these transactions. The very high cost equity capital in this country leads us to try to conserve it. So you get refinancings that basically liberate equity and replace it by debt because those who are managing portfolios place a very high value on equity and expect immediate short-term returns.

Corporate America, has taken its pension funds, given them to pension managers, and then on a quarterly basis, ranked those pension managers against all other managers, putting immense pressure on them to generate quarterly performance. As a result, these managers, because they are on a quarterly treadmill, absolutely have no loyalty in a longer-term sense to a company that may be making long-term investments which can't conceivably pay out over the short haul.

So while I can certainly agree with Mr. Light that there is some benefit to getting investors to take a long-term perspective, if these people were on our boards they would simply say, "Why don't you jack up the price of the stock tomorrow morning because we're going to sell our position and we don't really care about what's going on 10 years down the road." Particularly in highly capitalized corporations in the United States, the ability of investors to get in and out in a very short period of time accentuates this short-term problem.

In sum, the most important force that is structuring the financial environment today is the existence of these large pools of investment capital and the willingness of their manager, to take on more risky debt and to demand far higher returns on their equity. This is causing equity to be in short supply to be used less than in the past. There is no way the financial system, can correct that because we are intermediating flows that exist in the marketplace.

Senator **Kassebaum**. Thank you, Mr. Chairman. I know we're out of time and there's a vote on. If I may just ask one more question, I'd like to explore this with you, but I'm also curious regarding Europe 1992 and if the Europeans would be successful in establishing a common currency, which I think is open to question, but if so, could we look at an Anglo-European currency? Should we even be thinking in those terms at this point?

Mr. **Corrigan**. Let me take a stab at that, Senator.

First of all, I think that the likely evolution of developments in Europe are such that a common currency is a good distance down the road. Clearly, the fundamental momentum that is behind the forces for European integration are absolutely irreversible, but when you get to the point of talking about a common currency you are talking about a form of integration that politically and otherwise I think is down the road. So I don't see that as a likely development any time soon after even 1992.

A THREE CURRENCY WORLD

But assuming it does happen, which frankly I think it will, although I wouldn't even guess as to the timeframe, then I think some very profound questions do arise in terms of relationships among currencies. I think Mr. Rohatyn from time to time, for example, has suggested, if I'm not mistaken, Felix, a three-currency world—a dollar, a European currency and a Japanese or Pacific Rim currency. Those kind of issues will arise but I think they are down the road.

As I suggested even in my own statement, I personally think we've got some more immediate problems in the 1992 context.

Senator KASSEBAUM. And all the more important it seems to me to address our own problems to put us in a strong position to deal with 1992 or what that might lead to as far as a common currency.

Mr. CORRIGAN. Absolutely.

Senator KASSEBAUM. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Kassebaum.

We're on the second set of bells on this vote which means we must leave right now in order to make it. We will come back very shortly and I've just instructed the staff that the first senator back should reconvene the hearing and take their time in the question period. So it will be interesting to see who that is. I'd like it to be me so I'm going to go as quickly as I can. But I think we're making very important progress today getting these issues on the table and getting the blend of opinion that we're getting here.

So the committee will stand in recess briefly here while we do this roll call.

[Recess.]

Senator ROTH. It's my understanding that the chairman has asked the first Senator to return, no matter how junior on the committee, to reconvene the hearing and begin with the questions.

Gentlemen, one of my principal concerns has been the lack of personal savings in this country and, while there's a great deal of discussion, the reaction on the part of at least some of our economists there isn't much we can do about it.

I don't happen to agree, and I'd just like to ask you some questions in this area. I thought the IRA was a very successful effort, that it did result in some new and additional savings. It did not merely transfer from other kinds of savings.

The first question I'd like to ask, do you think tax incentives can promote personal savings; and if so, what should we do about it tax-wise and otherwise, too, as far as that's concerned?

Mr. CORRIGAN. Well, let me respond to that first, Senator, and others can join in.

I think the first and the most important thing we have to do as a nation is get rid of the dissavings in the form of the Federal budget deficit. It is just very, very clear.

Senator ROTH. But it's not an either/or proposition, is it?

Mr. CORRIGAN. I'll come to the rest of it in a minute. Unless or until we achieve that fundamental step, I am very hard-pressed to see how we can get enough relief from the kinds of things that you're talking about. So I think that's the first priority in my judgment by far.

Now on the IRA question in particular, the fact of the matter is that in the decade or almost a decade in which we had the IRA our private savings rate was lower than it's ever been in history. Now you might say—and I think this is an appropriate comment—imagine what it would have been if we didn't have the IRA. And I accept that. Which is another way of saying, yes, there may be things that can be done in the area of tax policy that are consistent with a higher rate of savings and I would single out a comment that's relevant to the earlier discussion about leveraging and all the rest of it and that is in the area of capital gains taxation, double taxation of dividends, that directly or indirectly, it seems to me that those are areas in which very constructive things could be done if we had the financial wherewithal to get them done.

The difficulty is that almost all of those cost money from a revenue point of view in the short run, even though I think they would generate revenue in the long run.

Senator **Roth**. And of course the political problem is that those are tended to be looked upon as benefitting the more affluent.

Mr. **Corrigan**. They do have that appearance, but to the extent they work in the direction of fostering real investment, not funny money investment but real stuff, they clearly in my judgment are compatible with a stronger overall economy that works to the advantage of all.

Mr. **Reed**. Senator, I agree 100 percent with Mr. Corrigan that from a macroeconomic point of view the fiscal deficit clearly must be the first priority if you are going to have a significant change in the national saving rate.

Nonetheless, our experience is that consumers do respond to new savings products such as the IRA, and we have reason to believe, as apparently you do, that such instruments can promote savings.

The great dilemma for this country with regard to the saving practices of the household sector is housing. The true difference in the behavior of our household sector vis-a-vis the household sector of Japan or Germany has to do with household formation—and the attendant need for mortgage credit.

The flow of funds statements published by the Federal Reserve show that the household sector in the United States accumulates financial assets at a rate typically in excess of 10 percent of GNP on an annual basis. That gross accumulation of financial assets, which importantly is the amount available for capital formation, is in the same range as a percentage of GNP as in either Japan or Germany.

In this country, however, the household sector borrows back, depending on the interest rate environment, 5 to 7 percent of GNP. This simply does not happen in either Germany or Japan.

By far, the greatest borrowing by the household sector in the United States is for home mortgages. We are lending $200 to $300 billion a year of net new money for home mortgages. I think this is socially desirable. It has contributed to a standard of living in this country that in fact is higher than in Japan, regardless of what the numbers say. So the dilemma is, if you want to raise the American household savings rate to 5 percent, you will have to make the consumption of housing more expensive. And I think most of us would agree that this would not add to the well-being of the American people.

We do not save first and buy our homes second. We have a very efficient home-lending industry that allows consumers to borrow against their future earnings potential in order to buy homes. That lowers the savings rate in this country.

Senator ROTH. Let me just make a comment. You're not going to touch housing. At least I hope not, not with my help. But at the same time let me point out in the case of the Japanese, depending on the figures, they have savings of 12 or 14 percent——

Mr. REED. In the household sector, yes.

Senator ROTH. If not higher. I'm always mystified by the fact that so many people seem to think that tax incentives don't work and yet some of those same economists will argue to provide incentives to winterize homes to save energy. If it works in one area, I think it works in another.

My concern is that after I listen to people I get the feeling they believe there's nothing we can do. It seems to me we've got to adopt some kind of a program that provides incentives and stick with it a while. You're not going to change habits in 2 or 5 years. Part of the problem, I suppose, regarding consumerism, is we have too much advertising. I'm not suggesting that we do anything about that, but the great thrust in this country is to buy on credit, and the banks and the financial institutions help with that. Somehow we've got to reverse this behavior. It seems to me we've got to try some tax incentives to see if it won't work long term.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Roth.

Senator Sanford.

Senator SANFORD. Thank you. I thank all of you for your testimony.

I'd like to ask Mr. Reed a question and ask Mr. Rohatyn to comment on what he says. You outlined five things that you think ought to be done to modernize our banking regulations. I must say I hadn't thought about the fifth one. It's an intriguing idea. I thought about the fourth one, putting together the insurance industry and the banking industry, but I hadn't thought about it out loud very much for obvious reasons.

The first three, however, are things that we've been working on and have been talking about for some time. In the last session, we passed what I thought was a fairly good banking bill. Now it's been suggested and suggested again this morning that the regulators are beginning to do a good many of those things, but perhaps in a haphazard way.

Now what is your thinking about what this Congress ought to do or this committee in particular should do to address the issue of securities and banking? Should we bring back up the banking bill that we passed last year and discuss it again and elaborate on it or should we attempt to start from scratch? Do you think we ought to put that bill back in?

Mr. REED. Senator, I couldn't claim to be an expert on the details of the process and how it would most rapidly move forward.

I share your view that you had a good banking bill last year that clearly moved in the direction each of the witnesses this morning suggested would be appropriate. Whether it is most effective within the culture of this institution to simply bring this up again or to start from scratch, I frankly do not know. But I share your sense that the bill got passed last year was a step in the right direction.

In either instance, I would urge you to move quickly whether with a new bill or with last year's.

Senator **Sanford**. There was some objection to essentially doing away with Glass-Steagall and I thought maybe Mr. Rohatyn might want to elaborate on how you view these three recommendations of broadening the bank powers.

Mr. **Rohatyn**. Well, Senator, again, I'm not an expert on the details of bank bills, but I do notice that Glass-Steagall is being eroded by the regulatory process much more rapidly than by the legislative process and I think with everything that's happening in the securities industry, with the levels of debt that are being accumulated throughout the economy, and by what I stated about my concern about the undercapitalization of both the banking system and the securities industry, I think we ought to have some time to really see how things are evolving before we go much further.

ELIMINATE GLASS-STEAGALL

I think that, although I sympathize with John Reed's view that Glass-Steagall should be eliminated in order to permit the banks to do pretty much everything, they are getting rather close to that; and I'm not sure, as I said earlier, when you look at the conflicts of interest created by very large fee-driven transactions where the credit is now driven by the fee structure rather than historical credits that were essentially driven by the interest rate spread based on risk and reward——

Senator **Sanford**. If we have time, I want to come back to the leveraged buyout and mergers issue.

Mr. **Rohatyn**. So my answer to you would be to wait and see how things evolve.

Senator **Sanford**. Let me ask Mr. Corrigan a question and ask Mr. Light to comment on that.

You have talked about interest rates. I take very seriously the fact that we are running up a quarter of a trillion dollar new debt each year which is actually the real deficit. We say we are reducing the deficit through Gramm-Rudman but we all know we are not reducing the deficit. It's simply that we see Social Security and other trust funds that we inappropriately apply to the bottom line. We will have another trillion dollars in debt in the next three budgets that will put our national debt total at over $4 trillion.

Is this a matter of urgent concern? Should we be sitting here day after day saying, well, we'll carry this Gramm-Rudman one more year, or is this something that we need to get on with?

Mr. **Corrigan**. Senator, the first thing I would want to say here—and I believe this is vitally important—that the budgetary deficit, the trade deficit and the savings deficit, if you will, are all intimately and inexorably related. They should be thought of, in my judgment, as something of an isosceles triangle because they are all the same phenomenon, looked at from different sides of that triangle.

I regard the long-term implications of where we are right now as very dangerous indeed, and a particular element of that danger as I see it is not only are we accumulating debt in the government sector at a very, very rapid rate, but we are now accumulating external debt at a very, very rapid rate.

If you go back to 1981, the last year in which the United States had a current account surplus, we were in balance sheet terms the largest creditor nation in the world—in balance sheet terms, with about $140-odd billion plus. At the end of 1988, that $140-odd billion plus had become a minus of $540 billion, which is 10 percent of the GNP. Now that's a swing in 8 or 7 years of $700 billion.

Now it's no accident—it is absolutely no accident that that arithmetic result approximately coincides with the cumulative current account deficit over that period, nor is it any accident that it approximately coincides with the budgetary deficit over that period.

So I think it is a matter of great, great concern and one of the things that worries me is the frequency these days with which I read commentary to the effect of "Well, what's the problem? We've had this stuff for the past bunch of years and everything has been fine."

The CHAIRMAN. There's even a song that's called, "Don't Worry, Be Happy."

Mr. CORRIGAN. As I like to say, Mr. Chairman, there's a bias in my thinking and the bias is I think I'm paid to worry. So maybe I worry a little too much, but I can't let that opportunity, Senator, pass without being rather forthright in stating my worries.

The CHAIRMAN. Senator Graham, have you had a first- round turn yet?

Senator SANFORD. I think Mr. Light was going to comment.

The CHAIRMAN. I beg your pardon.

Mr. LIGHT. Let me quickly say that I agree with all of that insofar as it pertains to the long-run importance of dealing with that deficit.

But the reality of it is that in terms of the short-run imminent problems, it's one of the easiest things to put off until another day. So I think there's a constant temptation to put this one off. If we continue to do that in the very long run it will be one of the most important choices that future generations will pay a price for.

Senator SANFORD. Thank you very much.

The CHAIRMAN. Thank you, Senator Sanford.

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

I'd like to come back to the question I raised initially and that is how to stretch the time frame in which economic decisions are evaluated. You all have touched upon that in various ways.

One of the immediate issues that the Congress is going to face will be the question of restoration of capital gains which several of you commented on as possibly one of the levers to stretch that time frame.

Could you give us some greater specificity as to what you think the characteristics of a restored capital gains should be, particularly one of you used the term a sliding rate system. I believe that was you, Mr. Light. What do you think the horizontals and the verticals should be in that sliding scale?

Mr. **Light**. Well, I think I might have mentioned it and I think one of the other witnesses did, too.

Apart from the rather particular breaks, the touchstones to me would be a long-term capital gains rate that is considerably below the current income tax rate, and a short-term capital gains rate that might still be quite high. Indeed, perhaps higher than the current income rate.

Now I would think, as regards long-term capital gains rates, a meaningful distinction between that and the current income rate would be something like the old 50 percent. That would be a considerable benefit to anyone with long-term capital gains.

As regards the short-term capital gains, I would think having a capital gains rate substantially higher than the 20 to 33 percent rate would also make some sense. And I think you can slide it right down with a straight line if you'd like. As a practical matter, you might not want to have too many break points in it, but slide it down as a function of the period of time in which the asset has been held.

Mr. **Rohatyn**. Senator, if I might comment also, one of the things I suggested would be to reduce the capital gains tax but to also apply it to tax-free institutions. I believe that with a larger and larger bite of American capital totally exempt from taxes is something that at some point has to be thought about, especially when you combine it with the bias towards short-term behavior of institutions.

And if a tax-free institution today is faced with a 15 percent capital gains tax if it sells, as opposed to a no-tax if it holds or a higher tax if it sells in a shorter term, I think it will make a difference.

I think it will also make a difference in terms of restoring the differential between corporate combinations of mergers that are based on equity and that are tax-free under the code today for the individual shareholder and leveraged cash transactions that are taxable to the individual shareholders but tax-free to the institutions and would restore the economic differential that I think would be appropriate in addition to being a revenue-raiser at a time when certainly we could use it.

Senator **Graham**. Mr. Chairman, I would like to shift to another subject which is also an immediate one, and that is the issue of the savings and loan legislation.

S&L INDUSTRY BEING PHASED OUT

I sense that there is a fundamental question that hasn't been much focused on and that is whether there is an economic rationale for the savings and loan industry and if in fact the types of provisions that we are inserting into this legislation, particularly those that require rather rapid accumulation of capital in an industry that has shown almost no ability in the past to generate additional capital, is not a de facto statement that this industry is being phased out?

If the answer is that the S&L industry is in fact being phased out, what would be your recommendations as to the measures that should be included in this legislation to make this part of a restructuring of our financial institutions as graceful as possible and with as little aftershock to the financial services industry?

Mr. **Corrigan**. I would be a little reluctant myself, Senator Graham, to volunteer a specific comment to that question because I have some fear that as soon as I said anything most of the staff people sitting in the room would run down the hall and say, "Corrigan said this."

I do want to make a point, though. I would certainly agree that there is a very legitimate question about the need for a class of institutions that specialize in home mortgage lending, period. But I would caution, for what it's worth, that if a decision was made by the Congress as a whole tomorrow morning that we did not need a savings and loan industry, I would be willing to make a small wager that a year or 2 or 3 or 4 or 5 down the road we would be sitting here talking about a new bill to create just such an industry. I think that's just a political judgment coming from a nonpolitician, but I suspect that's the case.

The **Chairman**. Would you yield on that point?

Senator **Graham**. Yes.

The **Chairman**. Are you saying that would be driven by just political pressures or political pressures coming from unmet market needs, that you would have people out there wanting mortgages and not getting them?

Mr. **Corrigan**. I think, Senator, it would be driven by precisely the kind of thing Mr. Reed was talking about in terms of the very, very high priority we as a nation do put on housing almost as a divine right, and I think that's a priority that I personally would associate myself with. And I also think that Mr. Reed is quite right.

You can look at all these statistics of real per capita GNP in this country versus that country, but the fact of the matter is, I use the test of the naked eye and the test of the naked eye tells me that there is—notwithstanding the statistics—a higher standard of living in this country than is the case in many of the industrialized countries. And I think one very, very basic reason for that is the attitude that we have taken for many, many years about housing.

So economically, I think you could probably make a decent argument that a specialized lending industry devoted to housing per se probably is not needed. But as I said, I'd be willing to make a small wager that if you made that judgment you'd be back here in a couple of years working on the fine-tuning of a bill to recreate that industry.

Senator **Graham**. The assumption of that is that if the S&L industry were to lose its separate identity that there would be a deficiency in funds available for housing.

Mr. **Corrigan**. My instinct, Senator, is that that probably would not in fact be the case. I'm not making an economic judgment there.

I would also say, if I may, that if we do continue to have a thrift industry, which is fine with me by the way, I do think that as a general matter the regulatory, supervisory, framework on the issue of capital, for instance, should be brought in an orderly way into alignment with what we have in banking. I don't think some of these vast differences in regulatory structures within the lending industry are sustainable or justifiable.

Mr. REED. Mr. Chairman, speaking as the chairman of an institution that originates between 5 and 7 percent of the home mortgages in the United States, the distinctions between the two industries are quite artificial from a practical point of view.

It would be as beneficial for many S&L's to be permitted to become banks and gain additional powers as it would be for banks to incorporate S&L's within their structure. When we talk about things like Glass-Steagall and the integration of S&L's and banks, sometimes banks view it as a one-way path. But it would be as beneficial for an investment bank to have banking powers as it would be for a bank to have securities powers. So I see this as a two-way road.

The savings and loan bill should provide for the gradual coming together of the two industries over time by permitting S&L's to acquire and become banks and by allowing banks to acquire S&L's and fully integrate them into their broader operations.

I can associate myself with Mr. Corrigan's comment that this would require supervisory, capital, accounting, and deposit insurance standards to become quite similar if not identical. But based on my own experience—and as I say, we have a major commitment to this industry, the need for home mortgages in the United States is a fundamental one and it will be met. Financial institutions will respond to this need simply because it makes sense in our economy to do so.

The S&L's were destined to get into trouble because they were forced by regulation to look at the marketplace too narrowly. I believe that banks, if given the opportunity to acquire S&L's and to absorb them into their existing operations, will do so in a healthy way, without destroying the source of their services to the community. A combined industry over time will be more stable and more useful to our society than today's artificially separated system. There are very healthy and dramatically successful S&L's in California, for example, that do at least as good a job as any bank in that marketplace in serving the community. Some of these S&L's might want to take on some banking activities as well. There is at least one very healthy S&L in California we know of that would like to become a bank. It's not going to change its business. It's simply going to take advantage of being in an industry that is held in higher regard by the consumer.

Market research indicates that the name "bank" is more attractive to the consumer. So S&L's would gain by the ability to become banks.

The CHAIRMAN. Thank you, Senator Graham.

Several things I'd like to get into and I appreciate the patience and I won't keep you here all day. I want to just make a reference to a chart here.

DEBTOR NATION PROBLEM

This illustrates the point that Mr. Corrigan was raising earlier about this debtor nation problem. As a person who's maybe in as good a position to see the dynamics of that debt accumulation, I think your warning to us and to the country today is a very powerful message and one we'd better pay attention to.

I'm struck not just by the size of the numbers, but the dynamics of the curve. And you were making a reference to that in your narrative remarks. I think on a chart in color you can see it very, very vividly.

If you look at our creditor nation status which we lost in about 1984 in balance sheet terms, what's interesting, if this chart were to go all the way back in time—it begins in 1977—we were a creditor nation going all the way back to 1914. So through the depression, through the world war, through all kinds of things, we managed to do quite well in comparative global economic terms as measured by our asset position internationally.

But then, as you mentioned, we started to erode that balance and we came down and we cross that debtor nation line for the first time since 1914 and we've continued on down through the end of 1986 and I've put the quarterly add-ons here if you took the white space out and compressed all the red area.

The purpose of looking at this I think is to start to fathom what it means when you're at this point in the early 1980's and you're here at the end of last year and you're riding this curve at this rate of speed. To me, this is just like an airplane with its wings off in terms of the rate of descent into this debtor's hole.

TRILLION DOLLAR INTERNATIONAL DEBT

Now I think the estimates that the New York Federal Reserve Board is using as to where this trend line is taking us suggest that about 1992 or thereabouts we're going to hit this trillion dollar international debt figure. Is that about right?

Mr. CORRIGAN. Yes.

The CHAIRMAN. I don't know what a trillion dollars in international debt means in macro, macroeconomic terms for this country, but I've tried to put that question to some financial experts like yourselves and when I've been able to do that I've gotten some very interesting answers as to what it means. I'll give you one without naming the source because I'd like to ask each of you what you think it means or what the implications are.

One group of important international financial experts and players thought about it for a while and were just sitting around a table and their response was—and I'm paraphasing, but in effect they said, "Look, we're not smart enough to tell you what it means to have a trillion dollar international debt by 1992, but it scares us to death and we really think we'd be fools as a nation to find out." In other words, let's get off that kind of a trend line and not wake up one day and find that we've sort of gone off the edge in terms of the outer bounds of the margins we ought to work with. That's one view.

I'd be interested in your views. I'd like to just go right down the table. Mr. Rohatyn, what is your view?

Mr. ROHATYN. Well, Senator, the first thing it means to me is that when we hit a trillion dollars of foreign debt we will be hitting $60 to $70 to $80 billion of interest payments that we will be remitting abroad. So that if we're trying to bring our current account deficit into balance, it means if we have $140 or $150 billion trade deficit today that we have to add those interest payments to that trade deficit, which would mean we would need a swing of over $200 billion in trade annually to bring this into rough balance. Now that is a huge swing in terms of any national effort that I can imagine.

Second, a trillion dollars is about 90 percent of all of the Third World debt today when you add it all up. So that in terms of magnitude for one country to have that sizable debt seems to me to put it into somewhat starker perspective.

The third issue, which Jerry Corrigan referred to earlier, is that I think it is a matter of national prudence not to depend on foreign capital to the extent that we become dependent upon it because it isn't necessarily always friendly and the markets may not always be friendly. So that we are leaving our entire economy at the mercy of market functions or foreign government functions which are not predictable and I don't think that's a prudent thing to do.

The CHAIRMAN. And this is really outside our contemporary economic experience. I mean we've all grown up in a time frame where we haven't had to really think about that idea because it was just outside the scope of our recent contemporary history. Is that not right?

Mr. ROHATYN. Well, Senator Garn mentioned his trip into orbit. This is financial orbit that we're traveling in. We don't know where we're going to come down, Senator.

The CHAIRMAN. Mr. Corrigan.

Mr. CORRIGAN. Let me, if I may, briefly make two clarifications for the record, since this has now become such a prominent part of the discussion.

For the record, we should say that the statistics on your chart or indeed the ones I used probably overstate things, at least to an extent. All those numbers are based on book values and there are some distortions arising from that. And relatively speaking, more of the U.S. assets abroad are in the form of direct investments that earn quite high rates of return relative to portfolio investments. That means that the problem may not be quite as bad as the raw numbers suggest.

But as I said before, I do view it with considerable alarm. What I think is vitally important that we understand is that if you pick a number, a trillion, in 1992 or 1993, something like that, that number assumes—assumes—in some ways, the best of all worlds because to get from where we are to there, you have to have those deficits coming down in a straight line over that entire period. In other words, an absolute deficit will still be there, but its size will be coming down. If deficits stay where they are today, you'll end up higher than a trillion dollars.

Again, I go back to my isosceles triangle. We have to shrink all three legs of the triangle in sync with each other. It's a package deal.

Now the only other point I would make—I'm not qualified to make but I'll make it anyway. That never stops me.

The CHAIRMAN. It will fit right in around here. Don't feel lonesome on that one.

Mr. **Corrigan**. In my judgment, this phenomenon may well have—that's my hedge—may well have important geopolitical implications as well. As I said, I don't feel particularly qualified to speak to that point, but it seems to me it inevitably arises.

The **Chairman**. Mr. Reed.

Mr. **Reed**. Senator, I have to join with that last point. Someplace on this path that you describe we're going to lose our will and our ability to be a leader in the world. You can already see some evidence of this with regard to various things, for example G–7 coordination issues. Even, the caution with which the President had to handle offers of economic assistance in his recent trip to Eastern Europe illustrates this. The deficit is stopping us from doing things we should be doing in terms of our leadership role both internally and externally. There must be many things Members of this Congress feel are important to our society which simply aren't on the agenda.

So if you were to ask me what single thing should we focus on, far more important than anything else is the loss of will. We will lose the courage of our convictions and the ability to assert our positions. As that happens we will also lose our ability to effectively act as leaders on geopolitical and, more importantly, geoeconomic issues.

The **Chairman**. I want to come back to that. Mr. Light.

Mr. **Light**. And even if we don't lose the will, we will lose the way. That is to say, we probably have even now I think given up the ability to determine domestic financial policy on the basis of domestic needs and, indeed, the higher that debt gets, the more it will have to be that we will determine domestic financial and economic policy on the basis of what foreign investors views might be or not be on a particular issue.

The other point to mention is this financial deficit is merely just the flip side of the trade deficit and it is the other reason why working on the problem of the international competitiveness of U.S. business is a terribly important thing to do, not just for the microreasons that have to do with each industry and each company, particularly where a serious national interest is involved, but because they have a major impact upon this macroeconomic feature of where we're likely to end up.

LOSING MOMENTUM ON THE GEOPOLITICAL INTERNATIONAL FRONT

Mr. **Rohatyn**. I'd like, if I may, Mr. Chairman, to just add my voice to especially what Jerry and John Reed were saying. Not only on the geopolitical international front are we losing momentum, but this deficit simply gives us an excuse to throw up our hands about domestic needs. And meeting domestic needs is as critical to meeting an international leadership position as anything else, whether that be in education and infrastructure, in health care, in all of the things that we are terribly deficient in. And unless we can deal with those issues and deal with them relatively soon, we're going to have a combination of domestic and international posture which we're not going to like and we haven't been in in 75 years.

The **Chairman**. If I just may react to what you all have said, two points—educational deficit, for example, the high school dropout rate in America running at about 24 percent and in Japan it's running at 2 percent. So ours is ten times worse. And if you think about our productive capacity going forward in time, what can we produce off each hour of human work, if fully a quarter of our population hasn't even made it through the high school level of training, it tells you that our ability to compete in the kind of sophisticated world that is now upon us and to produce the high value-added work product that we like to consume is an enormous deficit in one of these functional areas that bears on our future capacity.

If we're not able to produce at high levels of output pretty much across the entire base of our society, you start to lose all of the national income and output—it being the same thing in effect—that you have to get from your society if you want to start closing these gaps.

Let me relate another one. We had seated right at your table 2 days ago Bobby Inman, who of course was at the CIA—Admiral Inman, and we had Frank Carlucci, our last Defense Secretary, and we had Mr. Costello, who was the Under Secretary of Defense, looking at the ability of the United States to think in strategic terms in terms of our military readiness.

This committee has a responsibility to reauthorize what's called the Defense Production Act by September 30 of this year and that's really the only national law that's in place that is encompassing enough to start to capture sort of the muscle and strength of this question of how our economic foundation is doing, how is it positioned, where are we in technology, can we gear up in a wartime situation if we need to and so forth.

They gave us a very sobering message. They all expressed it somewhat differently, but the bottom line of what all three had to say was that America has to think and talk to itself and reason its way through today's problems in a brand new fashion.

Unfortunately, that's about as far as we have been able to get, that we've got a new problem. It's of epic scale. The world has changed. Our relative position has changed and it's eroding in relative terms.

We now need a process by which we collect those facts and talk to ourselves as a nation—to just use a euphemism, like "Team America," if we want to try to think and work together—the business sector, government, academic people, labor, what have you—citizens generally. We've got to have a means by which we collect ourselves around a table or in a room or in a work process where we decide what our plan is and how we divy up the work, not that that's central planning because nobody wants central planning and there are lots of examples around the world of central planning not paying off very well. But we need to be able to think and develop a strategy in a new way that is forced upon us by the fact that we've left an era and we have now gone speeding in to a new era that we are just beginning to comprehend.

And the financial structure is obviously very central to that, as you're here talking about today and you're all right in the middle of in one way or the other.

But I was struck by the fact that they were delivering a message about a time urgency and the need to think and do some things in a new way that really is a different kind of an isosceles triangle. They are in effect looking in on the same problems and coming to the same kind of bottom line as policy people who have operated up on this very high level, as all of you do.

So in a sense we're getting very important cross checks from other directions who are saying that "Don't worry, be happy" is really a false premise at this time and we've got some very serious problems and we're really behind the curve in understanding them and dealing with them.

I only take the time to say that because I think at some point along the way in these things we have to sort of try to figure out what it is we're hearing or perhaps is being said in different ways by different witnesses.

I want to just pose a couple of other questions and then I would like each of you if you would to respond to two or three questions for the record. We won't take the time to go into them today.

I want to do this as quickly as we can. Mr. Light, you say that you believe the evolution of bank products and services should include the continuing erosion of Glass-Steagall and I'm wondering by that if you're suggesting the gradual and eventually the complete elimination of Glass-Steagall, or are you suggesting maybe an erosion of Glass-Steagall only up to a certain point? What do you have in mind as you try to see what this transition would look like and where it would take us?

Mr. LIGHT. Well, I think for now I would exclude most of the equity oriented functions that securities firms do, including particularly the underwriting of equities from the kinds of activities that it would make sense to have banks and bank holding companies involved in.

But I think over the foreseeable future it would make sense to have them become active participants in the underwriting and trading of certainly most corporate debt securities and I think debt securities of other entities, that's the direction we seem to be headed now, and I concur that that's a sensible direction.

So I would make the distinction between debt versus equity, at least for the time being, and think of most of the activities associated with corporate debt and other entities' debt as being the kinds of activities that well capitalized banks and bank holding companies might well be allowed to do.

The CHAIRMAN. I don't know if any of the rest of you feel compelled to comment on that. If you do, I would be happy to hear from you.

Mr. REED. I have clearly said that I would like to see a merging of the industries. It would be as healthy for investment bankers to pick up traditional corporate commercial banking powers as it would for commercial bankers to have securities powers. In other words, I am looking for a more stable intermediary structure in which some of the well-capitalized, well-managed investment banks would become stronger by taking on commercial banking relationships as well. So it's not, from my point of view, a one-way street.

MAJOR INTERNATIONAL BANKS

The CHAIRMAN. Can I ask you, Mr. Reed, this question, and that is if you look at this change in the size of major international banks and who is in the top 20 and who isn't, and you can go back a few years and there was pretty good American representation and, unless I'm mistaken, at the present time of the top 20 I think you represent the only American bank that is left in that group.

How many of the top 20, by the way, would be Japanese banks, do you know offhand?

Mr. REED. I would have to guess it would be 6 or 7—well, 12.

The CHAIRMAN. It was 6 or 7 six months ago. It's now 12. I say that in jest, but obviously the trend line is moving that way. So 12 would be Japanese, 12 of the top 20. There is one American bank in the top 20. What does that mean? I mean what is the implication of that? Is that an important fact and what do we draw from it in terms of does this threaten us in some way?

Mr. REED. I believe it is important to the United States. We are in business to serve our customers. When American companies are looking for access to global financial pools, it is very important to the American economy that they be able to efficiently tap pools of savings that exist say in Tokyo or in Europe through an American intermediary.

Frankly, I don't think that it serves the American industrial base well nor, indeed, the American consumer well to have our financial services industry unable to intermediate these flows on behalf of our national customers. Today we are in a period of abundant liquidity, but in periods of crisis long-range interties and relationships with your customers really come to play. American companies operating around the world should have their natural suppliers to count on—and one is not sufficient as much as I would like to be the single player.

I believe it is in the interest of the United States for roughly 25 to 30 percent of the major players intermediating global capital flows to be American institutions with the natural loyalties and affinities they would have with their customer base. So it does constitute a serious problem, not only for our industry, but frankly for the American industrial base.

The CHAIRMAN. Mr. Corrigan, do you have an observation on that point about who is in the top 20 and who isn't?

Mr. CORRIGAN. Let me make just a statistical clarification. I have some numbers here on the top 50, and as of 1988 of the top 50, 23 are Japanese, 20 are European and 5 of the 50 are United States.

The CHAIRMAN. Let's just clarify that. Five are United States out of the top 50?

Mr. CORRIGAN. This is out of the top 50, right.

Let me respond on two levels, or three levels. First, especially in the case of the Japanese, we have to recognize that there are three sets of forces that have driven the explosive growth of the size of Japanese banks. One in recent years is the exchange rate phenomenon, and we have given your staff some statistical material with my testimony on that, two is their high savings rate and three is their very huge current account surpluses.

Again, we think of those being associated with a country, but especially in a case like Japan, those are really surpluses in the private sector that work themselves back into the financial system. So that, too, is tied up in these macroeconomic considerations, and it's important to recognize that.

Now having said that, I have always said that I was more interested in the list of the 50 best banks and not the 50 biggest banks, and I would like to see the United States dominate the list of the 50 best banks.

But I also have to concede that my own thinking on this point has changed over the past couple of years, Senator, and it changes because of a point that Mr. Rohatyn made earlier, and his term was critical mass.

There is now evidence of economies of scale in banking once you get up to $100 billion or so, but I think the critical mass phenomenon is important, and I think that is consistent with some of the things that Mr. Reed was talking about.

So I don't want to associate myself with the notion that big is beautiful per se. I'm not on that wicket at all. But I also have to concede that when I look at these statistics, especially in the broad context that we're speaking, I think once again they are symptomatic of some of the problems that I think we are both so concerned about.

RECIPROCAL NATIONAL TREATMENT

The **CHAIRMAN**. Let me ask you, Mr. Rohatyn, if I may, what should be the American response to countries that don't allow American financial institutions the same investment opportunities that we allow them in terms of access into our country, and we can think about it both ways. We can think about it just in terms of investment opportunities, and we can also just think about how financial institutions are treated in terms of whether or not we really have a truly reciprocal national treatment back and forth. Is that a problem we need to act on now and, if so, what do you have in mind that we ought to be thinking about doing?

Mr. **ROHATYN**. Well, Mr. Chairman, I think the whole question of foreign investment is already and is going to be more and more of a very sensitive political issue as well as an actual economic and security issue.

We have the most open market in the world with respect to foreign investment and with respect to acquisition of control of American companies by foreign investors, and that has probably been healthy and on balance it's probably all to the good.

First of all, we need the foreign investment desperately, and I would prefer us not to be in that position because it might make our views on the latter issue somewhat different, but we are so in need that we really cannot even consider putting any restrictions in the way other than those that exist already in the banking and the national security area.

But, again, as a matter of economics, if we are to maintain open trade because a lot of imported technology is coming in here that is necessary for a lot of industries, it seems we should be free to go abroad to make the investment abroad either by making the direct investment or buying control of businesses or establishing ourselves that would enable us to control the technology which we are now importing, and I think that's true both in terms of manufacturing and possibly even of financial services.

I don't know what the answer is specifically to your question, but I do believe that the issue of reciprocity with respect to investment is an important issue that applies not only to the financial sector, but to the general economic and manufacturing sector. If we are to maintain totally open borders here with respect to trade and investment, the investment side should be as much a part of our negotiations with our partners as the trading side.

The CHAIRMAN. I'm going to just pose one final question here given the lateness of the hour, but because you are the kinds of financial experts you are, and positioned where you are, you sort of have your thumb on the pulse of the whole national economic system. So while you are in financial services in one form or another, that's a good way to be able to measure what is going on in every other place in our overall economic system, manufacturing and what-have-you.

I'm inclined to draw the conclusion from what I'm hearing you say, but I want to state it, and if you agree with it, then I would like to hear you state it the way you might state it.

I'm drawing from what you're saying today that beyond the specific adjustments that have been laid out here, that there is an urgent need or an immediate need or a real sense of requirement now for the United States to take the question of its broad financial and economic strategy, structure being part of the strategy, to take that right up to the top of the list.

I mean we've got a lot of issues with global warming and disarmament, AIDS, and the drug problem and so forth and so on. I think I'm drawing from what I hear you say that our overall financial and economic strategy and structure and system and capacity to perform may now be in jeopardy in certain ways in a global sense. That we now have to take that up essentially to the top of the list, and maybe there are some other things up there, too. We've got to put this right up top and say that if we want to be able to be in position to do a lot of other things in the future in terms of foreign policy and geopolitical initiatives, like Mr. Reed says, or things in our own society in terms of education levels or drug wars or housing or whatever it might be, that we now need to craft for ourselves a strategy that includes a whole series of well-reasoned and managed adjustments as best we can work them out. We need to do it right now. I mean as quick as we can, and that the cost of not doing it is really now reaching, in your view as I hear it, potentially a very dangerous size in terms of the future of the country.

Now I would like each of you, if you would, to react to that briefly and tell us if that is right or how you might say it, and let me just go right down the table starting with Mr. Rohatyn.

Mr. ROHATYN. Mr. Chairman, I subscribe to that completely. I think for the foreseeable future, unless the world turns upside down, the world political power is going to be exercised by countries which very strong capital systems and financial institutions, countries that have strong technology and strong educational systems and much less emphasis on military power, and I don't believe we can deal with any of these issues unless our financial institutions and our financial structures are the leading institutions in the world and where we have a system where we are not capital deficient all the time, but we are capital producing and capital exporting rather than capital importing.

The CHAIRMAN. Mr. Corrigan.

Mr. CORRIGAN. Well, obviously, Senator, without associating myself with every word you said, I completely agree with the thrust of what you said, and I think using my words, which were a little different than yours, that your views are consistent with my testimony here this morning and I think the things you have said are consistent with things that I have been saying for a long time.

The CHAIRMAN. Mr. Reed.

Mr. REED. Senator, I share your feelings. Our first priority must be our internal competitiveness. Our relation to the global system touches on the issues that you've raised about education, drugs and so forth, and these tie rather directly into our ability to sustain our competitiveness on a global scale.

I would put second our trade and economic relationships with our principal allies in the north of the world, Japan and Europe. I hope that the GATT negotiations will create a framework within which some of these issues, including importantly agriculture, services, intellectual property rights, as well as some of the other more traditional items can be resolved.

Third, we have to better understand our relationships with the Soviets, Eastern Europe and China in what appears to be a different world.

The security issues, which have been such a priority over the past 40 years, must begin to move down in comparison with managing our economic interdependencies. Obviously the foundation of our national security tests on a sound economy and the well-being of the American people.

Finally, I can't miss the chance to say that I am quite concerned about our relations with the developing world. There are 5 billion people in the world—800 million of them live as we do in the north and 4.2 billion do not. Today, flows of capital are moving from the developing world to the developed—be it flight capital from some of the Latin American countries, be it Korea paying off its debt, be it Taiwan investing its trade surpluses in U.S. securities. As a result, 4.2 billion people are living in countries which basically cannot keep even their own savings within their borders. If this persists for a long period of time, it will have a very direct and negative consequence on our own society.

So as I consider our priorities, I have to make this fourth. I wish I could make it first, but I can't honestly. But the United States should think about the nature of the trade and economic relationships we have not only with our trading partners in Europe and in Japan, but also with some of these important economies around world, and I by no means restrict that to those with a debt problem. It touches on the four tigers in Asia; it touches on Turkey; and it touches on India just as much as it touches on some of the named countries in the debt crisis.

Mr. LIGHT. Mr. Chairman, I would share all that, including your statement and all the other witnesses' statements, and let me say one more thing. I think that the financial system and these particular problems that we have been talking about today aren't going to stand still no matter what this committee does. There is no alternative I think but that we find ourselves in what is a very fast changing financial system, including the markets, the intermediaries and the role being played by a variety of actors, both within this country and abroad.

I think that were this committee to do nothing about these issues, the pace of change would still be very fast indeed. The opportunity that you've got now is to get out ahead of some of these changes and make sure they take place in a way that is advantageous vis-a-vis a number of the rather important problems we have talked about, and I think the time is relatively short to be able to do that.

The CHAIRMAN. Gentlemen, let me just say how much I deeply appreciate your being here today. I appreciate it as a citizen and I appreciate it as the chairman of this committee.

We have just had Senator Sarbanes return, and Senator Sarbanes as head of the Joint Economic Committee probably gives as much thought to economic policy questions and the new economic world global environment that we live in as anybody here.

Let me just let him catch his breath for a second, and I think there is a question that he would like to pose here.

Senator SARBANES. Thank you, Mr. Chairman.

Gentlemen, first of all, I apologize I wasn't here and maybe you did cover the Third World debt question while I was away about which I forewarned you, but where are we on the Mexican negotiations if you can talk about them in open session?

Mr. REED. Senator, as you probably know, Citibank acts as the chairman of a 15-bank committee that is negotiating with the Mexicans even as we sit here. Obviously because we are at this stage, I am under some fairly significant constraints as to what I can say in public testimony.

If I can top line it, first I'm optimistic. As you probably know, there are seven American banks on the committee, but there are a majority of foreigners, including two Japanese, one French, one Swiss, one German and two British banks.

The chairmen of all of these banks around the world met with the Mexicans from Wednesday of last week at 4 in the afternoon until Saturday about 5 in the morning.

Through that process we achieved, both from the point of view of the Mexicans as well as the banks, substantial convergance on the shape and form of an agreement for Mexico. The agreement will provide for both debt reduction and debt service reduction as envisaged by Secretary Brady's proposal and, very importantly, it will satisfy Mexico's financing needs, which we broadly estimate to be approximately $9 billion over a period of 3 years in order to ensure that that economy has the ability to grow.

We were unable to announce an agreement at this time because there are important details that still need to be worked out.

So Minister Aspe and I agreed that the best way to proceed was to get the routine negotiating committees, the people who are technically closest to this, to move forward on a defined list of approximately five items that we wanted fully resolved.

That process is underway now. My own personal expectation is that it will be possible to reach an agreement within the framework of the Brady plan that provides for the financing needs of Mexico within a few days. If I could use an analogy, the mother to be is in labor, but I would not want to predict the moment the child will arrive.

Senator **Sarbanes**. Are you familiar with the concurrent resolution passed by the House of Representatives on Tuesday of this week?

Mr. **Reed**. I am familar with the broad outlines.

Senator **Sarbanes**. Well, it's a pretty strong statement about supporting the President to encourage the private creditors of Mexico to take certain actions to reduce Mexican debt in order to enable Mexico to achieve a sufficiently positive rate of economic growth. It also talks about prudent reserves for impaired foreign debt as well in the resolution.

So I guess it will now come over to our side for us to take a look at it, but we are obviously very anxious to move this process forward. There are lots of other countries that we have to address besides Mexico, which I think is generally appreciated I assume. Maybe that is one of the difficulties, but it has got to be addressed.

My own view is that the world economic prosperity is very much tied tc this problem, and for the United States it has enormous significance obviously.

I won't press you any further in an open session. I may take an opportunity to talk to you after the chairman adjourns the hearing.

Thank you, Mr. Chairman.

The **Chairman**. Gentlemen, let me thank you again for your testimony today. I think we have really had an important hearing here.

I want to thank, by the way, Mr. David Douglas who is seated over here who had a major role in helping to put this together today, and we appreciate all the work that he has done.

Let me also announce that all members have now been recorded on the two earlier votes, the vote on Mr. Francis Keating to be general counsel at HUD was unanimous with 21 members voting aye, and the HUD investigation was also voted out unanimously with all 21 members voting aye.

Gentlemen, thank you very much for your attendance today, and we will continue our discussions.

[The committee adjourned at 1 p.m., subject to the call of the Chair.]

OVERSIGHT HEARINGS ON THE CONDITION OF U.S. FINANCIAL AND INDUSTRIAL BASE

WEDNESDAY, JULY 19, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:05 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Alan J. Dixon presiding.

Present: Senators Riegle, Sarbanes, Dixon, Shelby, Wirth, Kerry, Heinz, D'Amato, and Kassebaum,

Senator DIXON. Ladies and gentlemen, Senator Riegle is otherwise engaged temporarily and has asked this Senator to proceed to chair this hearing until such time as he can arrive. I am delighted to see such a distinguished panel here this morning. My colleague, the Senator from Maryland, has another committee assignment and has asked that he be recognized first to make a statement.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Mr. Chairman, I am very appreciative of your courtesy. This is a very important hearing, and I very much regret that I am not going to be able to stay for it. I think this examination of the Defense Production Act and its relationship to competitiveness is a very important subject.

I just wanted to say a few words of welcome to the panel, and particularly to Norm Augustine, chairman and CEO of the Martin Marietta Corp. I have very great respect and admiration for him. Actually, I am privileged to serve with him on the Board of the School of Public Policy at the University of Maryland.

So I have seen him work in a somewhat different capacity, and I am here this morning to say that the committee is going to be privileged to hear from someone that I regard as an industrial statesman. I think he brings a breadth and depth of view and perspective not only to the business issues confronting his corporation, but to the public issues confronting our society, which is very much to be welcomed, and I am very pleased he is here before the committee this morning, and I apologize to him and to his two colleagues at the witness table that I am not going to be able to stay, but I will of course read their testimony and review the transcript of this hearing.

Thank you.

Senator DIXON. I thank my colleague from Maryland.

Does my distinguished colleague from New York State have anything to say before I make a brief opening remark? Senator D'Amato?

Senator D'AMATO. Thank you, Mr. Chairman.

I, too, have to go over to the Senate floor because we have a state authorization bill on the floor and I have an amendment that is pending.

I find it rather distressing that a nation with our great capability as it relates to research, as it relates to production has so oftentimes found itself victimized by its own success and not having the ability to carry these out into the world marketplace. I think that we are beginning to become more cognizant, and I look forward to the testimony of our distinguished panelists as to how we can help in this area, how government can loan itself to see to it that we don't lose the incredible technological advantages and advances that we make and how they can become better utilized, and with the Defense Production Act and what we in Congress can do to help that.

I am sorry I am not going to be able to be here, but I certainly will look forward to the testimony of our most distinguished panelists.

Thank you.

Senator DIXON. I thank my friend from New York State. I have a statement from Senator Sanford for insertion in the record.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you Mr. Chairman. I would like to welcome our distinguished panel of witnesses, Mr. Norman R. Augustine, one of Duke University's favorite sons and chairman and CEO of Martin Marietta, Mr. Robert W. Galvin, chairman of Motorola, Inc., and Mr. Stanley C. Pace, chairman and CEO of General Dynamics Corp., to today's hearing on the Defense Production Act and the state of our Nation's industrial competitiveness. The task we have before us, as members of the Banking Committee, is monumental. The committee, as authorized by the Defense Production Act of 1950, is to ensure that the American industries vital to our national defense, are kept healthy and ready in case we are faced with the need to mobilize our defense forces.

In the past decade we have witnessed the decline of many of our industries, namely the telecommunications, semiconductor, and computer industries, which have become very vital to the U.S. national defense forces. Now more than ever, it is critical that we examine the industrial base of the United States, and make the necessary efforts to regain our competitiveness in the world industrial arena.

Last week we heard testimony from former Secretary of Defense Carlucci, former Under Secretary of Defense Costello, and former Deputy Director of the CIA Inman. These gentlemen expressed to the committee the extreme nature of the situation. They testified that they felt a very real sense of urgency for the Government and industry to cooperate and focus more attention to R&D in order to enhance our technological industries. It was maintained by both the witnesses and the committee that a national strategy was needed to guide and direct the developing industries.

For some time, I have been exploring the idea of a new mechanism to develop a national science policy. It has been my belief that in order to become successful in the science and technological fields we need to develop a comprehensive, interdisciplinarian policy which will direct our efforts toward regaining our strength in the semiconductor, telecommunication, and computer sciences. With this policy in place we would feel secure that our industries are promoting the research and development which will enable us to regain our competitiveness in world markets, and ensure our defense resources are ready if mobilization is required. I would be interested in any input our witnesses might have regarding the need for greater coordination of our science education, research, and development.

I thank the chairman for holding this hearing on such a vital topic, important to all aspects of our national security. I thank the witnesses for being present and I look forward to their testimony.

Senator DIXON. Ladies and gentlemen, today we continue a series of hearings to explore the role of the Defense Production Act in enhancing our Nation's defense industrial and technology base and to discuss the broader issue of the competitiveness of U.S. industry.

In order to shape solutions to our defense industrial and technology base problem, we must continue to improve our data on the extent of the problems and focus our efforts on those problems.

We must also address the issue of investment by industry and by Government. Without a firm commitment from the Government to maintain consistent research and development and procurement programs, our defense industry is forced to constantly aim at a moving target.

In addition, our procurement system must begin to more efficiently foster dual use technology. Procurement policies that are formulated must reach beyond the defense sector and effectively tap the commercial sector that provides essential dual use technology. Providing solid procurement policies which encourage a more hospitable procurement environment is an important first step in setting the tone of the relationship between Government and industry. Working in an adversarial manner is not in the best interest of our national defense.

The reauthorization of the Defense Production Act provides the opportunity to begin shaping solutions that will affect our defense industrial and technology base today and for years to come.

I will soon be introducing the Defense Production Act amendments of 1989 together with my distinguished colleagues, Senator Heinz of Pennsylvania and Senator Shelby of Alabama. This legislation will address a major problem we are facing, and I look forward to working with the chairman of this committee and other committee members to see that sound reauthorization legislation is quickly enacted.

Ladies and gentlemen, we are honored to have before the committee this morning, Mr. Norman R. Augustine, chairman and CEO of Martin Marietta Corp. in Bethesda, MD; Mr. Robert W. Galvin, chairman of the board of Motorola, Inc., Schaumberg, IL;

and Mr. Stanley C. Pace, chairman and CEO of General Dynamics Corp., across the river from my hometown of Belleville, St. Louis, MO.

[The complete prepared statement of Senator Dixon follows:]

Alan
Dixon
U.S. Senator
Illinois

JULY 19, 1989

STATEMENT BY SENATOR ALAN J. DIXON
BANKING, HOUSING, AND URBAN AFFAIRS COMMITTEE

HEARING ON REAUTHORIZATION OF THE DEFENSE PRODUCTION ACT AND COMPETITIVENESS

MR. CHAIRMAN, TODAY WE CONTINUE A SERIES OF HEARINGS TO EXPLORE THE ROLE OF THE DEFENSE PRODUCTION ACT IN ENHANCING OUR NATION'S DEFENSE INDUSTRIAL AND TECHNOLOGY BASE, AND TO DISCUSS THE BROADER ISSUE OF THE COMPETITIVENESS OF U.S. INDUSTRY. LAST WEEK WE HEARD FROM EXPERIENCED FORMER GOVERNMENT MANAGERS WHO CANDIDLY SHARED THEIR CONCERNS ABOUT CURRENT TRENDS. MANY BASIC ISSUES WERE COVERED, RANGING FROM WHICH INDUSTRIES TO CONSIDER ESSENTIAL, TO THE NEED TO HAVE BETTER VISIBILITY REGARDING THE EXTENT OF FOREIGN DEPENDANCY IN CRITICAL ITEMS. I LOOK FORWARD TO CONTINUING THOSE DISCUSSIONS TODAY.

IN ORDER TO SHAPE SOLUTIONS TO OUR DEFENSE INDUSTRIAL AND TECHNOLOGY BASE PROBLEM, WE MUST CONTINUE TO IMPROVE OUR DATA ON THE EXTENT, AND FOCUS ON THOSE PROBLEMS. RIGHT NOW, WE HAVE LIMITED VISIBILITY. WE ARE OPERATING LIKE A HORSE WITH BLINDERS ON! ONLY WHEN WE REMOVE THE BLINDERS WILL WE BE ABLE TO REALLY ASCERTAIN THE EXTENT OF OUR FOREIGN DEPENDANCY. THE PRIME CONTRACTORS ARE ONLY RESPONSIBLE TO BE COGNIZANT OF THEIR FIRST-TIER SUBCONTRACTORS. SUBCONTRACTORS IN TURN ARE ONLY COGNIZANT OF THOSE ONE TIER BELOW THEM, AND SO ON, UNTIL THE LARGE SUPPLIERS OF THE BASIC COMPONENTS ARE REACHED. IT IS HERE AT THE SUPPLIER BASE AND THE SMALL LOWER-TIER SUBCONTRACTOR LEVEL THAT THE PROBLEM APPEARS MOST SEVERE. I SUPPORTED LEGISLATION IN THE DEPARTMENT OF DEFENSE AUTHORIZATION LAST YEAR TO 'PEEL BACK THE ONION' IN SEVERAL MAJOR WEAPON SYSTEMS TO GET A CLEARER PICTURE. THESE EFFORTS ARE NOW UNDERWAY, BOTH AT THE DEPARTMENT OF DEFENSE AND AT THE DEPARTMENT OF COMMERCE. WE LOOK FORWARD TO THE RESULTS.

THE VISIBILITY ISSUE WAS ALSO ADDRESSED IN THIS YEAR'S DEPARTMENT OF DEFENSE AUTHORIZATION BILL, WHICH WE ORDERED REPORTED LAST FRIDAY. IT PROVIDES MODEST FUNDING FOR THE DEFENSE DEPARTMENT'S DATA BASE - THE DEFENSE INDUSTRIAL NETWORK, OR DINET. BEYOND VISIBILITY, WE MUST ALSO ADDRESS THE ISSUE OF INVESTMENT BY INDUSTRY, AND BY GOVERNMENT. WITHOUT A FIRM COMMITMENT FROM THE GOVERNMENT TO MAINTAIN

CONSISTENT RESEARCH AND DEVELOPMENT AND PROCUREMENT PROGRAMS -- THE ELUSIVE GOAL OF STABILITY -- OUR DEFENSE INDUSTRY IS FORCED TO CONSTANTLY AIM AT A MOVING TARGET. INVESTMENT STATEGIES ARE IMPOSSIBLE, OR VERY SHORT TERM. WE PROVIDE FEW INDIRECT OR INDIRECT INCENTIVES TO INDUSTRY TO ENCOURAGE INVESTMENT IN MANUFACTURING FACILITIES OR EQUIPMENT, ADVANCED MANUFACTURING TECHNIQUES, OR IN WORKFORCE TRAINING. HOW, THEN, CAN WE HOPE TO MAINTAIN THE COMPETITIVE EDGE THAT THIS NATION HAS ENJOYED FOR THE LAST SEVERAL DECADES? THE SIMPLE ANSWER IS, WE CAN'T. WE MUST BOLDLY STEP FORWARD, AND PROVIDE THE STABILITY AND COMMITMENT THAT INDUSTRY REQUIRES.

THE STATEMENTS OF ALL OF TODAY'S WITNESSES NOTE THE IMPORTANCE OF THE TECHNOLOGY PUSH PROVIDED BY THE PRIVATE COMMERCIAL SECTOR. OUR PROCUREMENT SYSTEM MUST BEGIN TO MORE EFFICIENTLY FOSTER 'DUAL-USE' TECHNOLOGIES. THIS NATION DOES NOT HAVE A DEFENSE INDUSTRIAL AND TECHNOLOGY BASE THAT IS SEPARATE FROM OUR NATION'S COMMERCIAL BASE. AS SUCH, FEWER TECHNOLOGIES WILL BE EXCLUSIVELY DEVELOPED IN THE DEFENSE SECTOR FOR DEFENSE USE ONLY. THE COSTS ARE ALREADY ALMOST PROHIBITIVE. IF THE COSTS ARE TO BE KEPT MANAGABLE, MORE AND MORE OFTEN, THE EMERGING TECHNOLOGIES THAT THE DEFENSE SECTOR UTILIZES WILL HAVE TO COME FROM THE COMMERCIAL SECTORS OF OUR ECONOMY. TODAY HOWEVER, BECAUSE OF THE ADVERSARIAL PROCUREMENT ENVIRONMENT, MANY GOVERNMENT CONTRACTORS ARE TAKING STEPS TO ISOLATE THEIR DEFENSE SUBSIDIARIES FROM THOSE ENGAGED IN COMMERCIAL PRODUCTS. INDUSTRY IS VERY CONCERNED ABOUT GOVERNMENT ACCESS TO CRITICAL BUSINESS INFORMATION, SUCH AS PROPRIETARY RIGHTS JEAPORDIZED BY MINOR FEDERAL SUPPORT TO DEVELOP A PRODUCT. THESE ARE OFTEN TOO GREAT A PRICE TO PAY FOR THE RETURN THAT CAN BE EXPECTED. IN ADDITION, THE THREAT OF SUSPENSION ON THE BASIS OF ACCUSATION, OR THE DEBARMENT OF A WHOLE COMPANY FOR THE TRANSGRESSION OF ONE SMALL DIVISION ALSO WEIGHS HEAVILY ON A CONTRACTOR'S MIND. PROCUREMENT POLICIES THAT ARE FORMULATED MUST REACH BEYOND THE DEFENSE SECTOR, AND EFFECTIVELY TAP THE COMMERCIAL SECTOR THAT PROVIDES ESSENTIAL 'DUAL-USE' TECHNOLOGY.

I BELIEVE IT IS THE GOVERNMENT'S RESPONSIBILITY TO SET THE 'TONE' OF ITS RELATIONSHIP WITH INDUSTRY. THE ARMED SERVICES COMMITTEE IS CURRENTLY WORKING ON THIS PROBLEM WITH THE NEW LEADERSHIP AT THE DEFENSE DEPARTMENT. PROVIDING SOLID PROCUREMENT POLICIES WHICH ENCOURAGE A MORE HOSPITABLE PROCUREMENT ENVIRONMENT IS AN IMPORTANT FIRST STEP. WORKING IN AN ADVERSARIAL MANNER IS NOT IN THE BEST INTERESTS OF OUR NATIONAL DEFENSE.

THE REAUTHORIZATION OF THE DEFENSE PRODUCTION ACT PROVIDES THE OPPORTUNITY TO BEGIN SHAPING SOLUTIONS THAT WILL AFFECT OUR DEFENSE INDUSTRIAL AND TECHNOLOGY BASE TODAY AND FOR YEARS TO COME. I WILL SOON BE INTRODUCING 'THE DEFENSE PRODUCTION ACT AMENDMENTS OF 1989' TOGETHER WITH MY DISTINGUISHED COLLEAGUES SENATOR HEINZ AND SENATOR SHELBY. THESE AMENDMENTS PROVIDE A BROAD ARRAY OF IMPROVEMENTS TO

MODERNIZE THE ACT, EXPANDING THE REACH AND ENHANCING THE UTILITY OF THE AUTHORITIES PRESENTLY CONFERRED ON THE PRESIDENT. IN ESSENCE, THE AMENDMENTS WILL MAKE THE DEFENSE PRODUCTION ACT A MORE EFFECTIVE TOOL FOR BOLSTERING OUR DEFENSE INDUSTRIAL AND TECHNOLOGY BASE. APPLICATION OF THE ACT IS LEFT TO THE FURTHER DELIBERATIONS OF THIS COMMITTEE, OR THE PRESIDENT.

MR. CHAIRMAN, I AGAIN WISH TO COMMEND YOU FOR YOUR LEADERSHIP IN THIS AREA. I LOOK FORWARD TO TODAY'S TESTIMONY FROM THE DISTINGUISHED PANEL OF INDUSTRY WITNESSES BEFORE US. THANK-YOU, MR. CHAIRMAN.

STATEMENT OF NORMAN R. AUGUSTINE, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, MARTIN MARIETTA CORP., BETHESDA, MD

Mr. **Augustine**. I appreciate the opportunity to speak with the committee. I would like to submit my written statement for the record and provide some supplemental remarks this morning.

Senator **Dixon**. Thank you. We appreciate that, and that will be fully reproduced in the record.

Mr. **Augustine**. The problems that confront the defense industry today are by and large a subset of a much broader set of problems that confront our national industrial base as a whole.

In World War II, U.S. industry delivered a new aircraft to the military every 10 minutes, day and night, and at the same time delivered a tank every 25 minutes, an artillery piece every 6 minutes. The record from the time a keel was laid on an individual Liberty ship until the ship went down the ways into the water was a little over 3 days.

That was done with an economy that in comparable terms was about a third of what we have today, yet when I cite those statistics to my colleagues and inquire could we do that today, I have invariably been greeted with frustrated laughter.

Many would say that we are not preparing to fight World War II again, and I would hope that is true, although I am not totally confident on that score. But even in lower tiers of conflict many of the same problems would still apply.

During the period of time I had the privilege of serving as Under Secretary of the Army, the U.S. Army provided a significant number of tanks to Israel during the war in 1973 in the Mideast. One of my responsibilities was to replace those tanks through new production. We were trying to surge only one item, and we found it extremely difficult, extremely time-consuming, and in fact it took several years at a relatively low rate, which was the best we could do to replace those tanks.

PRODUCTION PROBLEMS

The problem turned out not to be tank assembly. It turned out to be the subtier suppliers. Specifically, there was only one casting foundry that could build castings of the size we needed in the United States. There were others in foreign countries.

I cite this because much of the focus has been on prime contractors. I think the heart of the difficulty resides at the lower tiers of the structure with suppliers of components, materials, smaller items. In fact, I saw recently where of the top 50 electronics suppliers to the Defense Department, fully one-third are foreign companies now.

As production tends to move offshore, technology almost invariably follows that production because production is the machine that provides the funds to make the technology laboratories viable.

Unfortunately, there are many reasons for these problems. Some are internal. The acquisition process by which we procure equipment for national defense is approaching gridlock in my opinion. Our industrial executives in this country are far too often guilty of taking a very short-term perspective, although there are excuses we can offer.

In the case of our own firm, a few years ago we very proudly made an announcement that we were going to increase our spending on research and development because we had some very promising opportunities. Our stock dropped six points within a few days, and one-third of the institutional owners that owned us dumped our stock.

So there is a strong pressure toward short-term attention, and then there is the matter of the defense budget itself, which is now in the fourth year of a real decline in terms of total obligational authority, and that, too, exacerbates the problem the industry faces.

There are external causes of the problem—lower wage rates in foreign countries, which encourage placing production, including defense production, abroad. There is targeting of U.S. industries, and then there are both internal and external problems that relate to things like exchange rates, relative savings rates in various countries, and so forth.

But the key point I would like to make is that the defense industry really is no longer an island unto itself. In the past there was an arsenal system, a system of defense-dedicated companies, but today much of the strength for national defense comes from the commercial sector.

The semiconductor industry would be a classic example. Very few defense items today are not critically dependent upon semiconductors as their heart and soul. Yet there is an asymmetry. The semiconductor and the semiconductor industry are terribly important to the Defense Department. But the Defense Department is not, frankly, terribly important in terms of sales volume to the semiconductor industry.

We all know—and we will hear more, I am sure, from my distinguished colleagues—about some of the circumstances in that industry. The fact, though, in my judgment, is that the state of the art in semiconductors is being determined in the commercial marketplace, and how well the U.S. does in the commercial marketplace, rather than by anything the Defense Department could hope to do on its own.

What is the problem? Is the problem that the free enterprise system no longer works?

I think not. In my judgment, the free enterprise system is one of the two ingredients that has made America the great nation it is. The root problem, in my opinion, is that geographical, geopolitical boundaries no longer coincide with marketplace boundaries, and the consequence is that our Government can no longer impose unilaterally the rules of that marketplace.

DIFFERENT NATIONAL STRATEGIES USED

Other nations have chosen to have different national strategies than we. The principal difference I would cite is other nations have chosen to adopt a system of collegialism, cooperation between their government, their industry, including labor, their academia, and to have a strategy for how to apply that cooperation.

By and large, we have chosen not to do that except in a few cases, where we have enjoyed great success. If you go back to the old NACA that preceded NASA, there was a key ingredient to the leadership of the United States and the commercial aerospace market. It was a key ingredient to the strength of the aircraft industry as it supports national defense.

SEMATECH is another, I think, important example, which hopefully was started soon enough.

What can we do?

There are many things that can be done. I have cited some in my written statement. Certainly, there are conventional things, tax credits for R&D, tax credits for investment and productivity, an inverse tax on capital gains, depending on how long the asset is held. There is a need to fix the defense acquisition process, including more equitable progress payments and the use of contract types to properly distribute risk. Then there is the need to focus on the problems, such as this committee has been doing, through either the permanent committee structure of the Congress or through the creation of a joint or select committee.

The establishment of a Defense Working Group within the President's Economic Policy Council has been discussed, and that is a concept that I would endorse.

The notion of having the Secretary of Defense become a member of the EPC would also seem appropriate, and in balance with that, the notion of having the Secretary of Commerce play a much greater role with the National Security Council would seem to be in order inasmuch as national security depends upon commerce and a strong economy as much as it does in the long term on tanks and guns.

Today we have many companies leaving the industrial base. The CSIS recently did a study that showed that two-thirds of the contractors who in 1982 were selling manufactured goods to the Department of Defense have since left as suppliers to the Department of Defense. That is during a period when defense spending increased in real terms by about 50 percent.

COMPANIES BEING PURCHASED BY FOREIGN FIRMS

Some of these companies that are leaving the base are being purchased by foreign firms. Furthermore, the market is declining due to changes in the defense budget, and I believe that under present policies, if continued—and I underline "if continued"—it is very difficult to justify even bidding on many of the programs pursued by the Department of Defense.

The adversarial relationship that exists between the DOD and its industry makes it much more rewarding financially, if not more pleasant otherwise, for companies to focus on their commercial businesses. If this were to happen, I think it would be a great disservice to national defense, to our country, and in fact to those companies.

Mr. Chairman, I thank you and the members of the committee for permitting me to make these comments, and I certainly welcome the opportunity to answer any questions you might have.

[The complete prepared statement of Norman R. Augustine follows:]

STATEMENT OF

NORMAN R. AUGUSTINE

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

MARTIN MARIETTA CORPORATION

* * *

BEFORE THE

COMMITTEE ON BANKING, HOUSING,

AND URBAN AFFAIRS

UNITED STATES SENATE

* * *

WASHINGTON, D.C.

JULY 19, 1989

Good morning, Mr. Chairman and members of this distinguished committee. I am Norman R. Augustine, Chairman and Chief Executive Officer of Martin Marietta Corporation.

I welcome the opportunity to appear before you to discuss a subject that is crucial to the security and welfare of our nation. You have asked for my views on the capability of American industry to meet future national defense requirements. This is an issue that troubles me, as it does you, and one to which I have obviously devoted substantial professional attention in my past role in the Department of Defense, in my current capacity in industry, and past and present in my association with the Defense Policy Advisory Committee on Trade and the Defense Science Board. While I will not suggest that I am in possession of anything approaching all the answers, I will be pleased to share my views on the subject with you.

These hearings are most timely on several counts. For one thing, of course, the Defense Production Act expires on September 30th of this year and hopefully the hearings will provide a valuable contribution to the reauthorization process. Beyond that, however, they are most timely because the world today is at an economic as well as political crossroads. The Chairman of the Joint Chiefs of Staff has called this a period of "uneasy transition," one in which U.S. military strength and the state of the supporting industrial base will remain vital to the future of this country and to the cause of peace and freedom around the globe for many years to come. Under these conditions, the ability of the U.S. defense industry in particular, and U.S. industry in general, to support defense needs as well as compete in the world economy is perhaps the most crucial question before the country at this time.

I would like to offer some general observations on the overall topic of our defense industrial base, which I have described in the past as our "industrial order of battle." Traditionally, we Americans have been able to think of this country's mighty industrial capability as perhaps our greatest weapon in any conflict. During World War II, President Roosevelt very accurately talked about the arsenal of democracy, and that indeed is what our industrial base has been ever since, for our own armed forces and for our allies as well.

For some years now, technology has been the key to our security and to our strategy. The "technological order of battle" has joined the "industrial order of battle" as a critical factor in the national security equation, and clearly we are presently in danger of losing valuable ground in both areas.

On one hand, the Soviet Union continues to conduct a vast research and development effort as part of its overall military program, in addition to acquisition of Western technology. The result is that, while the United States still leads the USSR in most basic technologies, the gap continues to narrow virtually across the board. Nor should we overlook the fact, in this dawning and hopeful era of "glasnost," that Soviet military power remains and

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will remain a central element in the international balance. That is a matter of simple realism.

At the same time, we now find that a substantial portion of today's advanced technology in the critically important field of defense electronics and other areas traces its origin to the commercial rather than the military sector. This is a very significant and relatively new trend. Thus, success in the marketplace betokens long-term commercial viability which contributes to the industrial base and in turn supports national defense. The loss of commercial strength also generally leads to a loss of technological leadership as well, in a vicious spiral that further diminishes national defense potential.

Against this background, I strongly feel that we must see a change in national policies affecting the defense industry and the defense industrial base if we wish to retain a strong capability to provide high technology systems for national defense. With the members of this committee, I have been interested in the health of the industrial base for many years. During this period, there have been a number of major studies of this important subject, for a few of which I have been privileged to be a contributor. The appendix to this statement contains a list of recent reports, including brief synopses as I view the reports. I would hope the committee will elect to insert this appendix into the record as part of my testimony before you today. These reports uniformly describe an erosion of the defense industrial base which I consider a matter of great concern.

Studies of the defense industrial and technological base conducted prior to the current decade focused primarily on issues relating to mobilization and surge -- that is, to how quickly our defense industry could respond to a major crisis. These earlier studies took for granted that this country's industrial base would remain intact, that we would retain our technological edge on the rest of the world, and that we would remain substantially independent of foreign sources for critical materials in time of need.

However, as subsequent studies have noted, our industrial base is being seriously eroded. Productivity growth has lagged, our technological edge is diminishing, and we are increasingly dependent upon foreign sources for parts and systems as well as for materials. In addition, the nature of many large defense firms also has changed. Many -- primes as well as subcontractors -- are now part of multi-market corporations, and the return on investment for the defense market is not favorable. These changes were noted as early as 1980, in the final report of the Defense Science Board Task Force on Industrial Responsiveness.

The situation has not improved since. All the more recent studies, regardless of the focus, have reported the continuing decline of America's defense industrial base. And all have singled out the increasing difficulty of doing business in the defense marketplace as a leading cause of the decline.

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Before proceeding further with my own overview of the problem of an eroding industrial base, and my recommendations, I want to emphasize that I personally feel the evidence is clear. We have a problem of great magnitude to this nation, one that calls for an urgent and determined response. We have seen a gradual slide toward mediocrity and reduced capability in the defense industrial base that calls for bold and innovative remedial action. Some have gone so far as to suggest we need the kind of energetic all-hands response usually associated with the period after Sputnik, not to mention Pearl Harbor.

As you in this committee are well aware, industrial base issues have been with us for a number of years. Over this period, the Defense Production Act of 1950 has remained the legislative focus for the nation's ability to provide weapons, material, and contractual services needed for a strong defense. In essence, the DPA was designed to realize four main objectives: (1) ensuring that we have both the capacity and capability to surge production to meet war mobilization requirements; (2) stockpiling to eliminate or reduce the nation's foreign dependency on essential raw materials; (3) protecting domestic sources for critical items; and (4) preserving critical technological skills that are necessary to sustain a strong industrial base.

Although I would like to see the Defense Production Act reauthorized, it also is my judgment that the act has not achieved its basic objectives in recent years as documented in the successive reports we have discussed. I believe the task before us is to identify the basic, underlying reasons that the act is no longer fully effective, and to take action as appropriate to solve these problems.

The four questions that you asked me to address constitute an excellent basis for discussion of defense industrial base issues and possible solutions. I will provide direct answers to your specific questions and then follow with a more generalized discussion.

1. Which key industries must be maintained to ensure the nation's defense?

There are two basic key industry groups that are essential to the nation's defense. They are the electronics industry and the platform industry. The latter includes firms engaged in research, development, and production of systems for ships, tanks, ordnance, aircraft, spacecraft, launch vehicles, missiles, and propulsion. Prime contractors, suppliers, vendors, technical services, and systems integrators represent elements of the industrial base that are subsets of the two basic industries. Also, I list in a later section some of the most important -- but by no means all -- technologies that are crucial to a sound defense industrial base.

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2. Are any of these industries in competitive decline?

Yes, I believe that a large proportion are experiencing a relative decline in competitive terms or face very real challenge in the marketplace. I would particularly cite such industries as the semiconductor industry, shipbuilding, machine tools, and materials.

3. What are the principal domestic and international reasons for competitive decline?

There are four principal aspects of the problem which I will discuss at more length under the headings Global Interdependency, Technology, Acquisition, and People.

4. What steps should be taken to reverse this competitive decline?

Recommendations in the final part of this statement provide some suggestions for meeting this broad range of complex problems.

GLOBAL INTERDEPENDENCY

Policies aimed at providing an adequate defense industrial capability have been severely impacted by industrial globalization. Economies of the free world have become increasingly interdependent upon each other for products, services, and technology. This trend is irreversible and relationships will become even more complex as a result of regional economic cooperation and shifting East-West security roles.

The U.S. can no longer think in terms of total self-sufficiency for all defense production without either lowering its standards, giving up certain capabilities, or significantly increasing its costs for defense. We need better definition today concerning the role of the U.S. vis-a-vis our allies and other friendly countries, not only in terms of collective security but also in terms of our collective ability to produce.

The relationship between a strong U.S. economy and national security also requires better policy focus as the defense industry becomes increasingly globalized and more dependent on commercially developed technology. Interdependent global economic ties are essential to maintaining a strong economy. Such global interdependency, when coupled with economic strength, provides a powerful means for influencing allies and adversaries. Any course of action for maintaining a strong U.S. defense industrial base needs to be carefully evaluated with respect to its overall effect on the economy, and on the economic relationships between the U.S. and its allies.

The U.S. and its major allies are fortunate to have by far the leading industrial capability in the world. Continued collaboration with each other will ensure that this collective industrial capability remains second to none. The challenge facing U.S. policymakers is to determine which capabilities must continue to reside principally within this country for national security purposes. Given the uncertainties of international politics over the long haul, coupled with the risk of disruption or interdiction in times of crisis, this is obviously a crucial question. It is, however, one that I believe we must face with the additional realization that, as production moves offshore, it is not uncommon for technology to follow it. While government policymakers have already identified several products and industries which must be protected for national security purposes, the criteria used to develop the list, and the methodology, have not been consistently applied and are subject to external political influences.

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A fall-out of global interdependency is an increase in foreign ownership of defense-related U.S. companies. This can be a two-edged sword. While foreign owners may infuse needed capital into a U.S. production facility, the effect over a period of time remains open to question. Foreign-owned U.S. companies may eventually become more dependent on parent company technology for development of future generation products rather than investing in new technology. Better analysis and systematic review of this issue is required before any conclusions can be drawn concerning the long-term impact on national security.

One troubling global trend that needs more policy focus is the practice by some countries of targeting industries critical to defense and national security. When a country selects one or more specific industries for development, subsidizes those industries to whatever extent is necessary, and establishes a worldwide strategy to gain market share at all costs, then it is often impossible for a rival U.S. company in and of itself to remain competitive even within our own borders.

There are U.S. trade laws which prohibit such targeting within this country. These laws need to be enforced aggressively. Multilateral trade negotiations should focus on much stronger enforcement mechanisms against industrial targeting on a worldwide basis. Finally, and most important, the U.S. government must maintain pressure through a coordinated and forceful government-wide approach to bilateral negotiations with countries that engage in industrial targeting.

An issue that often gets overlooked in discussions of the defense industrial base is the importance of defense exports. Defense exports make up approximately 15 percent of conventional defense production in this country. The importance of defense exports to the overall defense industrial base should raise some red flags, because the U.S. has not been doing particularly well recently. One major example is the sale of Tornado aircraft and other items by the British to Saudi Arabia. Over the life of the contract, it was

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originally estimated that approximately $30 billion would go directly into the European defense industrial base which otherwise might have been spent in this country. Recent estimates are substantially higher.

Not only does this cost U.S. jobs and add to the trade deficit, it also reinforces European resolve to develop its own defense systems without any U.S. content burdened with U.S. policy and acquisition controls. Such controls, including technology transfer restrictions, are forcing companies which want to participate as suppliers on foreign defense systems to conduct research and development, in addition to production, outside the U.S. Current policies do not adequately reflect the reality that the U.S. is not the only supplier of high performance defense systems in the world.

The flip side of interdependency, of course, is the global competition that also characterizes today's environment and bears heavily on defense capabilities as well as on the nation's general economic health. This is a vast topic in itself. But, insofar as it relates to today's proceedings, suffice it to say that I believe it is impossible to deal seriously with the state of the defense base without considering the overall matter of America's posture in the global marketplace.

TECHNOLOGY

The importance of technological leadership to national security cannot be stated too strongly. Technological superiority over our adversaries with sufficient margin to overcome a numerical disadvantage has been the cornerstone of our defense strategy since World War II. We cannot afford to let our technology base slide, even when budgets are austere, if we intend to maintain superiority in defense systems. This is particularly true in view of the increasingly rapid pace of technological change today, which makes advanced technology in many cases a truly perishable product.

Ultimately, the technology base must reside in the defense industry -- developed, to be sure, by a cooperative and coordinated effort among industry, government, and academia. Technology leadership requires a long-term strategy to invest as a country in those critical technologies that have high value-added potential, and which can be translated into effective fielded systems exhibiting greater capability, flexibility, and reliability at a lower cost than the systems they will replace. For example, a list of such technologies would include microelectronics for all applications from guidance and controls to image and signal processing; semiconductor manufacturing to ensure a continuing domestic supply of analog and digital devices; photonics which has the potential to replace certain electronic devices in the next generation of weapon systems; software methodology for improved reliability and lower cost; information processing and intelligent systems for such applications as command and control and smart weapons; robotics for teleoperation and fully autonomous systems; advanced materials for composite structures for naval, air, and space systems; advanced sensors for improved detection; propulsion; aerodynamics; "stealth;" and so forth.

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It is not important to be complete here in identifying all critical technologies that require continuing attention. But it is important to note that there is remarkable unanimity among government and defense industry managers on the need to focus resources on selected key technologies with a reasonable degree of coordination. This country has always been a leader in science and technology. If we have a failing in this area, it is in the process of translating our technology advantage into fielded systems in a timely way.

To attack this problem, we should have more opportunities for prototyping advanced technology systems. Advanced concept prototypes encourage innovation in technology application and allow system performance and costs to be validated before full-scale development decisions are made. System design and integration is at the heart of a strong defense industrial base. This is the step where real innovation occurs in the way advanced technology is applied, coupled with advances that come from manufacturing process control, concurrent engineering, and other techniques to achieve enhanced quality and performance at lower cost.

ACQUISITION

Our federal acquisition system is central to the health of our defense industrial base. However, I am deeply concerned that many of the modifications to the acquisition process undertaken in the past several years and currently underway are counterproductive. Consider the following:

- As early as 1971, the report of the congressionally established Commission on Government Procurement stated that the federal procurement process was at the point of "breakdown" due to an excessive number of laws and regulations. The problem is far worse today than it was in 1971. There has been a substantial increase in laws and regulations since that commission made its recommendations, particularly in the past several years.

- A number of changes have been made to the defense acquisition process, especially since 1984, that have been characterized as "reform" measures. While many may have merit in terms of solutions to particular problems, the cumulative effects on contractors have been very serious. The attractiveness of defense contracts has been significantly decreased by measures that require contractors to share in development costs, assume greater risks by using fixed-price development contracts, absorb higher levels of financing of operating costs, and pay taxes on income much earlier than previously required.As a result, contractor investments in unstable programs are at unaccceptable levels. External financing requirements have almost doubled. Return on assets is now below the cost of capital. And defense industry stocks are discounted by approximately 40 percent,

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thus complicating industry's ability to raise essential capital. The bottom line is that many industry firms are rejecting defense business in favor of more profitable, less risky, and less troublesome business.

- o Policies tend to be inconsistent. For example, an overriding mandate for competition with price as the dominant factor inhibits defense industry investments and increases dependency on foreign sources.
- o Other policies, one must report:
  - -- preclude the recognition of and full reimbursement of contractor independent research and development costs;
  - -- focus on near-term objectives, discouraging long-term investments by funding programs through a succession of one-year contracts;
  - -- reduce federal outlays and demand industry share development costs of systems for which the risks of return are very high and to a large degree arbitrary;
  - -- require fixed-price development contracts which greatly increase contractor risks, inhibit quality design, and encourage overseas dependency;
  - -- recognize the importance of quality, but do not provide funds to build in quality during critical front-end stages of development;
  - -- fail to encourage development of suitable manufacturing processes essential to the efficient production of complex new technologies;
  - -- build instability into the system, precluding or hampering the ability of private companies to plan for the future. This has been called the "number one problem" for both government and industry in effectively managing the acquisition process.
- o This committee should understand, also, that an extremely unfortunate and extremely intense climate of adversarialism now surrounds the defense acquisition system. This climate, indeed, may be the most serious negative factor affecting the defense industrial base. Lack of trust is exemplified by excessive auditing and oversight, by treating transgressions against one or more complex administrative rules as criminal offenses, and by public disclosure of alleged violations which sometimes have little or no foundation and are certainly more the exception than the rule. The time, expense, and effort now required to bid and administer government contracts is on the order of 10 times as time-consuming and expensive as required for

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commercial sales. The taxpayer not only pays for these inefficiencies, but they also greatly detract from the strength and viability of the defense industrial base.

In closing on this topic, I want to emphasize that America's defense arsenal really is the private sector. It no longer is based in the national system of production facilities run by the Army and the Navy for many years. Our free enterprise process has served the nation well in the past and can serve it well in the future in defense as well as commercial pursuits. But it must not be inhibited beyond reason by a complex, inefficient, and hostile acquisition system.

I recognize that the Congress is concerned about all factors contributing to a decline in our defense industrial base. This hearing, in itself, is evidence of that fact. I urge that Congress, in the continued fulfillment of its heavy responsibilities in this area, thoroughly consider the full implications of new laws that further regulate, control, or restrict the overburdened acquisition system. The national interest demands that, at a minimum, we stop and fully assess the current acquisition process to ensure that it truly serves the nation by enabling the maintenance of a strong industrial base. Congress' role in this effort is pivotal.

PEOPLE

The foundation of our defense industrial base is educated and trained people, and I should say this subject is last but far from least in this statement. There are many statistics in circulation today that indicate a very large shortage of engineers and other technical people within the next decade. This shortfall, which in the first instance is a shortfall of our educational systems, poses a very serious threat to the nation's defense. It will affect both the government and industry sectors, and commercial and defense businesses.

A similar people problem relates more particularly to the government scientific, technical, and procurement workforces, as has been pointed out in virtually all recent studies. I have discussed this matter a great deal in the past and want to emphasize it again in this statement. Our government scientists, engineers, and key business decision makers must be thoroughly qualified to set forth and manage the government's interests in the defense acquisition process. Programs must be headed by competent, motivated, dedicated individuals who receive the support necessary to get the job done, who remain in place long enough to bring their capabilities fully to bear, and who accept responsibility for their actions.

Based on first-hand observation over three decades, our nation has been blessed with a long line of military officers and civilian public servants who exemplify the qualities of professionalism and integrity. There is concern, however, that the conditions of employment have so deteriorated in recent years that this depth and breadth of quality may well diminish to an

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unacceptable level in the years ahead. We must correct this problem by paying our public servants competitive salaries, affording them the prestige most deserve, providing for their training and professional development, and granting them the latitude to manage and accomplish. People are, in fact, far more important than new laws and regulations. Recruiting, training, and maintaining quality people is of prime importance, and this matter requires the most careful attention.

RECOMMENDATIONS

The challenge presented by the state of the defense industrial base is a broad one with a great many dimensions as suggested in these hearings, and I have discussed the four areas that I see as absolutely critical. In my judgment, however, perhaps our most fundamental need is for a central legislative focus in the Congress to exercise oversight in this whole broad area with its multitude of interrelated elements. I believe that the importance and the complexity of these issues requires such a forum to consider the multiplicity of options before us as a nation, the range of specific measures that can and are being proposed, and also to help prevent the creation of new problems while solving existing ones.

Accordingly, I would strongly suggest that Congress provide for special legislative focus on our nation's defense industrial base problems, either through the permanent committee structure, or by creating a joint or select committee. This review would entail consolidating studies, analyses, and actions designed to correct problems or deficiencies associated with the defense industrial base. The effort could also include the conduct of a broader analysis of legislation proposed in response to particular interests. Finally, appropriate legislative activity within the relevant committees could implement the recommended proposals influencing the varied aspects of the industrial base.

The Congress must grapple with the range of diverse issues raised in these hearings, including the nation's posture in the global marketplace, the need for a vigorous defense technology base program even in the face of constrained budgets, the provision of a strong professional workforce, the problems and opportunities of scientific and technical education as related to the industrial base, acquisition system problems that are resulting in a weakening of the defense industrial base, foreign ownership of key industries, and many other matters which deserve prolonged attention.

I understand, similarly, that some consideration has been given to establishing a Defense Working Group within the President's Economic Policy Council and designating the Secretary of Defense as a member of the council. I would favor both of these actions, along with the corollary appointment of the Secretary of Commerce to sit on the National Security Council to deal with international economic and trade issues, as proposed by Admiral Inman before this committee last week.

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Because the nation's posture in the global marketplace underlies the strength of the defense industrial base, prime attention must be turned to the broad topic of economic renewal. In my judgment, we must develop a working partnership that brings together the collective resources of government, the industrial sector including labor, and the academic community to "out-compete" foreign nations in key industrial areas. I strongly support an industry-led, business-government partnership focused on technological innovation and aimed at creation of a national industrial strategy. One example in this area is Sematech in the field of semiconductor technology, and there are other current initiatives and approaches. Contributions to development of the commercial aircraft industry by the old National Advisory Committee on Aeronautics -- NASA's predecessor organization -- have frequently been recalled as an example of highly productive government-industry interaction in an earlier era.

I realize this is an area that can be a philosophical and an operational minefield, but I also believe it is one where we should move ahead with perspective, balance, and a joint approach to the nation's best interests. I am not talking about central planning. The Soviet Union tried that and failed. I am talking about a cooperative, collegial, coordinated approach that recognizes the realities of a global marketplace in which U.S. companies often find themselves in uneven competition with foreign nations. Free enterprise has changed the world and it will continue to do so. But, in my view, we must act realistically on behalf of U.S. free enterprise in a new economic environment wherein market boundaries no longer conform to geopolitical boundaries and other nations are very successfully playing by other rules.

We must, further, establish a financial environment focused on investments in technology, on advanced manufacturing facilities, and on long-term objectives through such means as tax credits for investments in research and productivity and a capital gains tax inversely proportional to the length of time an investment is held. Among other measures, we also should encourage an increased personal savings rate by consumption taxes or other devices to raise the level of investment in national growth which, in the long term, is the essence of the nation's economic health as well as defense industrial capabilities.

In closing, I want to say again that I appreciate your giving me the opportunity to join you here today. I will of course be pleased to answer any questions that you may have.

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APPENDIX

SUMMARIES OF RECENT REPORTS ON THE STATE OF THE U.S. DEFENSE INDUSTRIAL-TECHNOLOGICAL BASE

Defense Science Board Task Force on Industrial Responsiveness (Department of Defense, Washington, D.C., December 1980)

Analysis:

Productivity in the defense industrial base has been lagging, in large part because of low levels of capital investment compared to U.S. manufacturing in general. The larger defense firms -- both primes and subs -- have changed character in the last 10 to 15 years. They are now part of multi-market, multi-product corporations, and must compete internally for the limited capital available. This capital is not being invested in the defense sector but in areas promising higher yields and lower risks. The instability of defense programs has made defense contracting less attractive. This, in turn, has led to growing dependence on foreign sources for critical materials and many parts and components such as electronic parts.

Recommendations:

The defense industry needs to emphasize a vigorous cost-reduction program and establish practices that encourage a strong supplier base. The industry should also work with non-defense members of the industrial community to create a more favorable climate for capital formation. The Department of Defense needs to promote greater stability in its business dealings with the private sector: make greater use of multi-year contracts, index progress payments to the prime interest rate, and establish appropriate incentives for defense contractors.

U.S. Industrial Base Dependence/Vulnerability -- Survey of Literature (Mobilization Concepts Development Center, National Defense University, Washington, D.C., December 1986)

Analysis:

This report surveyed a total of 13 defense studies, of which seven were initiated within the Department of Defense and six were directed by or performed for Congress. The report found that significant foreign dependencies exist for major weapons systems -- cutoff would mean serious disruption of production. Growing foreign dependency exists in the electronic technology base critical to advanced weapon systems. Foreign dependency is not being addressed in any systematic or effective way. The U.S. is losing both smokestack and high technology industrial capability.

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Recommendations:

The Department of Defense needs to manage foreign dependency in a focused, effective way. Second, the DoD should take an active leadership role within the federal government to assure that the national security implications posed by the deteriorating U.S. industrial and technological base are addressed in national policies and programs.

Report of the Defense Science Board Task Force on Semiconductor Dependency (Office of the Under Secretary of Defense for Acquisition, Department of Defense, Washington, D.C., February 1987)

Analysis:

U.S. military forces depend heavily on superior technology to win. Semiconductors are the key to leadership in electronics. U.S. leadership in this vital area is being lost. It is no longer possible for individual U.S. semiconductor firms to compete independently against world-class combinations of foreign industrial, governmental, and academic institutions which have benefited from more benign financial and structural environments abroad. U.S. defense will soon depend on foreign sources for state-of-the art technology in semiconductors. The Task Force views this as an unacceptable situation.

Recommendations:

The Task Force recommends a number of actions to address this problem. The most important of these is for the Department of Defense to encourage, and actively support with contract funding, the establishment of a U.S. Semiconductor Manufacturing Institute, formed as a consortium of U.S. manufacturers. The purpose of this consortium would be to engage in the long-term research and development necessary to keep the U.S. in the forefront of this vital technology.

The Defense Technology Base: Introduction and Overview -- A Special Report (U.S. Congress, Office of Technology Assessment, Washington, D.C., March 1988)

Analysis:

For about three decades, U.S. national security planning has relied on superior technology to offset Soviet superiority in manpower and equipment.

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But reliance on superior technology cannot be taken for granted. At this time, the nation has specific concerns about: 1) the continued ability of the Department of Defense and its contractors to develop the technology it needs; 2) the ability of the DoD and the defense industries to turn these technologies into useful, affordable products in a timely fashion; and 3) the ability of DoD to exploit the technology that is being developed worldwide in the private, civilian sector.

Recommendations:

This report does not make specific recommendations. Rather, it identifies problem areas and outlines the options available to Congress in addressing each area. In particular, the report expresses concern over the following issues:

-- a heavy burden of government rules, regulations, safeguards, and procedures that stifle the ability of DoD to develop and exploit technology;

-- the lack of an effective system for high-level planning and coordination; and

-- the lack of a clear government policy and coherent strategy for dealing effectively with dynamic trends in the international high-technology economy.

Bolstering Defense Industrial Competitiveness: Preserving our Heritage -- the Industrial Base -- Securing our Future (Report to the Secretary of Defense by the Under Secretary of Defense for Acquisition, Washington, D.C., July 1988)

Analysis:

The United States is no longer self-sufficient in all essential materials or industries required to maintain a strong national defense. The problem is compounded by the fact that the Defense Department's peacetime requirements generally amount to only a small fraction of an industry's capacity. By itself, the DoD is incapable of sustaining the industrial base on which it depends. American industry must, on its own, remain commercially competitive in the global economy. But the DoD can assist American industry both to remain competitive and to support the national defense.

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Recommendations:

The report outlines six "strategic thrusts:" (1) forging the most effective relations with industry; (2) improving the acquisition system; (3) establishing defense industrial strategic plans that support our military strategic plans; (4) developing manufacturing capabilities concurrent with the development of weapon systems; (5) laying the foundation now for the technical skill base required for tomorrow's defense needs; and (6) ensuring that industrial base issues important to our defense benefit from the full spectrum of potential policy remedies, when appropriate.

Lifeline in Danger: An Assessment of the United States Defense Industrial Base (Prepared by the Air Force Association and the USNI Military Database. Published by The Aerospace Education Foundation, Arlington, VA., September 1988)

Analysis:

The United States is facing one of the gravest challenges to its leadership of the Free World since it assumed that role at the end of World War II. It is no longer the "Arsenal of Democracy" as it was in the past. The decline of America's industrial and technological base, coupled with increased competition from abroad, has seriously weakened our defense capabilities. Because of dependency on foreign sources and other reasons, American industry has difficulty in meeting peacetime, let alone wartime, defense needs. Because of shrinking defense budgets and proliferating red tape, fewer companies are interested in doing defense work, and vital research is being neglected.

Recommendations:

The report recommends that the U.S. do more to support the domestic defense industry and reduce dependence on foreign suppliers -- although it concludes that we cannot achieve a completely independent defense base. The report further recommends that Congress "untangle and rationalize the mass of laws and regulations" that bedevil the procurement process. Finally, the report recommends the appointment of a presidential commission to conduct a thorough analysis of the problem and chart a comprehensive national plan to strengthen and uphold the nation's defense industrial/technological base.

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Final Report of the Defense Science Board 1988 Summer Study on the Defense Industrial and Technology Base (Office of the Under Secretary of Defense for Acquisition, Washington, D.C., October 1988)

Analysis:

The effectiveness of America's defense deterrent depends on technological superiority over our adversaries. The deterioration of our industrial and technological base has undermined our deterrent. Furthermore, globalization of U.S. defense markets has made our nation partially and irreversibly dependent upon foreign sources. Policymakers do not always take account of the impact of tax, trade, environmental, and other policies on our industrial and technological defense base. In addition, there is a lack of central management within the Department of Defense itself. DoD acquisition policies in particular are in need of reform.

Recommendations:

The report makes 10 major recommendations. In particular, the report urges greater high-level coordination and cooperation to strengthen our industrial and technological base, and to centralize and streamline acquisition policies. The report also recommends greater attention to ethical standards, and appropriate rewards to attract and hold high quality management and technical people.

Deterrence in Decay: The Future of the U.S. Defense Industrial Base (The Center for Strategic and International Studies, Washington, D.C., May 1989)

Analysis:

The U.S. defense acquisition system is "grossly inefficient." The leading cause of this inefficiency lies in unrealistic defense programming and budgeting. At least 25 percent of the cost of research, development, and procurement of military products is wasted because of the following factors: unnecessary oversight, auditing, and regulations; program instability and poor estimates; excessive performance requirements; and overspecification of product and process in defense acquisition. These factors amount to an "inefficiency premium" -- the price paid by the United States in its regulation of defense industries. Increasingly, taxpayers are becoming resentful of waste in the defense budget, and corporations are becoming reluctant to do business with the Department of Defense. Some are dropping out altogether.

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Recommendations:

If the United States is to arrest the erosion of its defense industrial base, Congress must streamline its procedures regarding defense oversight and budgeting. The object must be to adopt policies that are based on thinking and working "smarter not richer." These policies must include: more productive oversight of defense industries in peacetime to reduce costs; more rational planning, programming, and budgeting in the context of U.S. national security strategy; and selective incentives for firms in industries that are particularly disadvantaged in globally competitive defense markets or for industries in which it is especially vital to have a domestic production base.

NORMAN R. AUGUSTINE was born in 1935 in Colorado and attended Princeton University where he majored in Aeronautical Engineering, was awarded a BSE, magna cum laude, an MSE, and was elected to Phi Beta Kappa, Tau Beta Pi and Sigma Xi.

In 1958 in California he joined what is now the McDonnell Douglas Corporation where he held titles of Program Manager and Chief Engineer. In 1965, he served in the Pentagon in the Office of the Secretary of Defense as Assistant Director of Defense Research and Engineering. Joining the LTV Missiles and Space Company in Texas in 1970, he served as Vice President, Advanced Programs and Marketing. In 1973 he became Assistant Secretary of the Army and in 1975 Under Secretary of the Army. Joining Martin Marietta Corporation in 1977, he is now Chairman and Chief Executive Officer and previously served as President and Chief Operating Officer.

Mr. Augustine is chairman of the Defense Policy Advisory Committee on Trade (DPACT) and has served as president of the 40,000-member American Institute of Aeronautics and Astronautics of which he is an Honorary Fellow. He previously served as president of the 160,000-member Association of the United States Army; chairman of the Aeronautics Panel of the Air Force Scientific Advisory Board; chairman of the DOD's senior advisory group, the Defense Science Board; chairman of the NASA Space Systems and Technology Advisory Committee, and as a member of the NASA Advisory Council. He has been elected to the National Academy of Engineering and the International Academy of Astronautics of which he is a Trustee, is an Honorary Fellow of the Society for Technical Communications, a Fellow of the American Astronautical Society and a Fellow of the Institute of Electrical and Electronic Engineers. He is a licensed professional engineer in the state of Texas.

He is a member of the Board of Directors of Phillips Petroleum, Inc., the Riggs National (Bank) Corporation, the Ethics Resource Center, the Atlantic Council and the Wolf Trap (National Park) Foundation, and has served on Boards of the Colorado National Bank, Hoskyns Group plc of the U.K. as chairman, the American Helicopter Society, the American Productivity Center, the Air Force Academy Foundation, and the Research Triangle Institute. He has been on advisory boards to the White House, the U.S. Senate, NASA, the FAA, and the Departments of Defense, Army, Navy, Air Force, Energy, and Transportation, the General Accounting Office, and NATO. He is a member of the President's National Security Telecommunications Advisory Committee, the Chief of Naval Operations' Executive Panel, the Policy Council of the Business Roundtable, the Council on Competitiveness, The Business Council, and the Conference Board, and is a Member of the Corporation of the Draper Laboratory and a Principal of the Council for Excellence in Government. He is a Trustee of The Johns Hopkins University, an Honorary Member of the Faculty of the Industrial College of the Armed Forces and a member of the Advisory Council of the School of Medicine at Johns Hopkins. He has chaired advisory councils for Princeton University, the American University, the University of Maryland and the MIT Lincoln Laboratory, and served on advisory boards for the University of Colorado, Georgia Tech, Duke, Texas A&M, USC, Johns Hopkins, Florida State, the National Defense University and the Defense Systems Management College. He has been an Associate Editor of the *Defense Systems Management Review* and served on the Editorial Boards of *Astronautics and Aeronautics* and the *Journal of Defense Research*.

He holds an Honorary Doctor of Engineering Degree from Rensselaer and has four times been awarded the Department of Defense's highest civilian decoration, the Distinguished Service Medal. He has also received the Defense Meritorious Service Medal, the Army Distinguished Service Medal, and the Air Force Exceptional Service Medal. He is a recipient of the National Security Industrial Association's James Forrestal Memorial Award, the American Astronautical Society's Military Astronautics Trophy, the American Institute of Aeronautics and Astronautics' Goddard Medal, the Association of the United States Army's Distinguished Service Award, the American Defense Preparedness Association's Gold Medal and Knowles Award, the Society of Manufacturing Engineers' Gold Medal, the National Contract Management Association's Roback Award, the Armed Forces Communications and Electronics Association's Sarnoff Award, the Colorado ARCS Man of Science Award, the Boy Scouts Citizen of the Year Award, and is an Honorary Command Sergeant Major of the U. S. Army.

Mr. Augustine is Council vice president and a member of the National Executive Board of the Boy Scouts and has served on a State Board of the minority INROADS program. He is married to the former Margareta Engman of Stockholm, and they are the parents of a son, Gregory, who is an electrical engineer, and a daughter, Rene', who is a law student. He is author of the book *Augustine's Laws*, printed in English, German and Italian; holds a copyright on a calculator for baseball managers; and is listed in "Who's Who in America" and "Who's Who in the World."

Senator **Dixon**. I thank you very much, Mr. Augustine. I am delighted to observe that the distinguished Senator from Alabama has joined us.

Does he have a statement that he wants to make?

Senator **Shelby**. Mr. Chairman, I have an opening statement. I would like for it to be placed in the record, and then we can move on with the hearing.

Senator **Dixon**. Without objection, it will be reproduced in the record and also, I have a statement from Senator Garn, to be inserted in the record.

STATEMENT BY SENATOR RICHARD SHELBY

Senator **Shelby**. Mr. Chairman, I would like to commend you for scheduling today's hearing. You have other very important obligations right now yet were able to schedule this hearing as well.

I also would like to welcome this morning's witnesses. In the discussion of this issue, it is particularly important that we consider the comments of those within the industry. Gentlemen, I have read your testimony and found it very helpful.

The capability and competitiveness of the American defense industry is important for many reasons. Today, this Nation is one of the world's two military superpowers and the foreign policy of most Western nations has come to rely on the perpetuation of this position of strength. At present, we are comfortable in this position of leadership.

Yet, we cannot be complacent. Daily, we see the competitiveness of U.S. products slipping vis-a-vis our global competitors. We acknowledge that we have lost our edge in consumer electronics, and automobile manufacturing. However, we have also lost our lead in machine tools, and in many industrial materials such as steel plate and plastics. The deterioration of our defense base. It can be argued that our lack of competitiveness in VCR's, TV's, and automobiles has an indirect effect on defense capability, but our diminished competitiveness in machne tools and steel plate has direct consequences on our ability to mobilize quickly in the time of emergency.

I agree with our witnesses that it is time to act; it is time to ensure the viability and competitiveness of certain key industries. I support free trade practices in a perfect world. Until that perfect world arrives, however, and defense capacity is no longer necessary, I support putting America first. In some industries, we have permitted imports to weaken our domestic markets to the extent that we cannot comply with emergency production demand. I believe that America's position as a military superpower demands that we consider import restrictions in a broader context than that of free trade.

I am interested in the suggestions of today's witnesses in what they believe that we should do to restore our industrial manufacturing capacity to its former position of leadership.

Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR JAKE GARN

Senator **Garn**. I would like to welcome our witnesses here this morning to discuss the Defense Production Act and the broader issue of U.S. competitiveness. I look forward to hearing your thoughts on this critical issue. Let me begin by saying that I commend the chairman in his efforts to hold hearings on the Defense Production Act prior to its reauthorization. I believe we need to know more about our Nation's ability to mobilize industrial capacity in times of crisis.

As I have stated before. I support extending the current Presidential authority. Also, there are some industries which are necessary for national security requirements and have become more competitive because of consideration under the Defense Production Act. I would entertain legislation which strengthens the principles underyling the Defense Production Act without engaging in undo government interference in the marketplace.

As we look at the broad issue of competitiveness, it is important that the committee not forget its responsibility to extend the basic authority of the Defense Production Act by September 30.

Senator **Dixon**. We did your bidding in connection with a very fine man who will be in the Commerce Department shortly.

Mr. **Galvin**. Thank you, a very good young man.

STATEMENT OF ROBERT W. GALVIN, CHAIRMAN OF THE BOARD, MOTOROLA, INC., SCHAUMBURG, IL

Mr. **Galvin**. In the late 1930's, our company was a very modest car radio manufacturing company, about 400 employees, maybe about 20 or 25 engineers. My father, who founded our company, believed we were going to go to war. A lot of people thought that at that time, but he did something about it. He asked his handful of engineers how could we help the Army communicate better because all we knew was that they were planning to string wires between the forward and the rear trench of a battlefield. Couldn't those engineers possibly package a receiver like our car radio and a transmitter into a box held in one hand and make it possible for the Army to communicate?

And well before the Germans invaded Poland, that little company, without any specifications from the War Department, without any auditors, without any program of any kind that resembles our present defense establishment, had designed, tooled, and readied for production the handie-talkie of World War II. It became known as SER 536. It had its days of getting over NIH in the Army, but it got through and tens of thousands were produced.

I respectfully suggest that we need more, at the margin, of that kind of industrial preparedness and industrial competence and contribution.

Our company, Motorola, is now a big company. We continue to do the same class of things. We conceived of the radio telephone system known as cellular in the 1950's, and today we are the world's leading manufacturer of cellular base stations and subscriber equipment, as typified by the product that we introduced just 3 months ago here in Washington, a full function cellular portable telephone that will talk anywhere around the world.

I respectfully suggest it is that class of contribution, of competence, that is going to be essential to the defense establishment's needs of the decades ahead, particularly as the demands will be less apparent to the needs of the threats.

Those of us who are engaged in the defense business are very proud that we can work in the defense of freedom and preparedness of our country. We literally worship the gods of freedom and defense preparedness, if I can use an analogy from that seat of civilization that I just returned from, where I studied again the classical history with my family a few weeks ago.

But, frankly, although we like the gods, we don't like the religious rites that you require of us in order to continue to worship those gods. We don't like the rites of the Congress. We don't like the rites of the Defense Department. You are turning us off, and that is replete in our testimony.

We respect the people who have orchestrated the system that we have. All are working the system honorably and well, but I think the system is now counterproductive.

Incidentally, and very importantly, any of us who practice our roles of serving you do and intend to continue to serve with 100 percent compliance with any rule and regulation that your imagination creates, but they are wrong. I have two points that I would wish to make in my oral statement to you.

One, if you want to encourage the class of contribution that is illustrated anecdotally here from a little Paul Galvin or you want incrementally more of this class of contribution that can come from a large corporation, I respectfully suggest that you must determinatively do two things, without which, even if you do all the other wonderful things that you are now in quest of and that the Secretary is in quest of, all will be for naught.

One, literally take a picture, a snapshot of all that you are doing in the Congress, all the people, all the hearings, all of the laws, stack them all up, put them on display, and reduce them by a minimum of 50 percent, indiscriminately—I don't care which ones you do away with. Just do away with that much. Whatever the acquisition regulations are, the number of auditors, all of that kind of stuff that we have in the Defense Department, you have got to reduce those by a minimum of 50 percent. Practical people would say cut them out by 80 or 90, get them down to 10 percent. We accomplished the handie-talkie without any of those things. Start to trust us and we will trust our suppliers and we will trust you, and then we will start getting things done that need to be done.

The second thing is—and this one is going to be heretical, coming from a conservative like me—the American industrial system can no longer cope with the Japanese industrial system. That is permitting that society in essentially a risk-free mode to provide the means by which the competent people of that society are finding their way into very critical niches of technology that people in this country, industrialists in this country, cannot afford or be motivated to support.

And I will leave it at that for the statement that I am making here voluntarily. I will be pleased to respond to questions if you wish, but I respectfully suggest that there must be a review of the industrial system as it relates to the government. We are going to have to proceed ultimately within our society to preserving the motivation of the private sector initiatives in order for us to stand up to the differentials that are now accomplishable in the Japan industrial society but that cannot be accomplished in this society.

Thank you very much.

[The complete prepared statement of Robert W. Galvin follows:]

Testimony by Robert W. Galvin
Chairman, Motorola, Inc.
Before the U.S. Senate Committee
On Banking, Housing, and Urban Affairs,
July 19, 1989

Abstract: The U.S. Department of Defense must transform itself into a world-class customer. This would require setting very ambitious goals for quality, reliability and cycle time management improvement by the year 2000.

The nation also needs to establish a meaningful trade policy. Many of the problems of U.S. industry have been influenced by the absence of such a policy vis-a-vis Japan.

Testimony by Robert W. Galvin
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July 19, 1989

Introduction

Mr. Chairman, I would like to thank you for inviting me to appear before this committee today to offer my views on the competitive position of American industry and the implications for our national defense.

Today I would like to suggest that the Department of Defense must transform itself into a world-class customer. I am including, as Attachment A to this document, the testimony of Christopher B. Galvin of Motorola on June 2, 1989 before the U.S. Senate Subcommittee on Defense Industry and Technology. This testimony contained several suggestions for improving the operations and performance of the Department of Defense and the industries key to the U.S. military-industrial base. It noted that Congress could continue to pursue solutions to operational problems program-by-program, or institute a better approach by setting aggressive goals for quality improvement by the year 2000.

The testimony concludes that "Quality, reliability and total cycle time enhancements are fundamental to maintaining a viable U.S. military industrial base. Many of those industries lost to the U.S. industrial-military complex exit because they can't afford to do business with the Department of Defense, given its overly prescriptive and bureaucratic approach to conducting business. It's also true that some of these companies can't perform at world class levels of quality, reliability, and cycle time." Congress recognized this problem when it established the Malcolm Baldrige National Quality Award in 1987. It provides the platform by which we can regain our industrial leadership.

I would also like to suggest today that we establish a meaningful trade policy. Many of the problems of U.S. industry have been influenced by the absence of such a policy vis-a-vis Japan.

I. Industries Key to Our Defense

I will return to these proposals later, but first, I would like to address the question of which industries must be maintained to ensure our defense. Several organizations, both within and outside government, have examined this topic. The Logistics Management Institute, for example, has identified 215 critical industries in which the majority of the Defense Department's budget is spent.

While this indicates the overall scope of the issue, there are more than 20 technologies that have been identified as essential to the performance of current weapons systems, and critical to improving the capabilities of future systems. Six of these technologies are:

- Biochemical Engineering: Development of this technology would allow the U.S. to create new types of weapons, especially countermeasures against chemical and biological weapons. The technology could also be applied to artificial intelligence by using "10 percent of our brain design and neurological pathways to develop computers with capabilities and memories that far surpass what we have today."

- Microelectronics: Development of Very High Speed Integrated Circuits (VHSICs), preparation of superconducting wafers, as well as learning how to make these circuits radiation-hard.

- Gallium Arsenide Semiconductors: These compound semiconductors are inherently radiation hard and are the building blocks for micro and millimeter wave circuits.

- Signal Processing: Advancements in radar signature reduction will allow application of passive techniques to reduce the low frequency radar signature of aerospace vehicles.

- Hypervelocity Projectiles: For penetration of radiation-hardened weapon systems.

- Composite Materials: Next generation materials and structures will integrate sensors and countermeasures technologies. By the year 2000, airframe weight should be reduced 25 to 50 percent and fuel consumption by 20 to 40 percent.

The Defense Advanced Research Projects Agency (DARPA) has also put together a list of critical technologies, which is Attachment B to this testimony. A number of researchers also believe that process technology is our area of greatest vulnerability.

II. Key Industries in Competitive Decline

Many industries vital to our military-industrial base are declining in their ability to compete. Overall, the U.S. defense industrial base has shrunk dramatically in the 1980s. A recent study by the Center for Strategic and International Studies (CSIS) shows that in 1982, there were more than 118,000 companies providing goods to the Department of Defense (DOD) in the relevant defense sectors. In 1987, only 38,000 companies in those sectors provided such goods. *More than 80,000 suppliers stopped providing products to the Defense Department during this time period*. This shrinkage is more remarkable in view of the growth in the total U.S. manufacturing sector. The number of companies in those sectors providing goods to all buyers, not just the DOD, went from 99,000 in 1972 to 123,000 in 1982, and to more than 150,000 in 1987.

The decline in the number of firms providing manufactured goods to DOD also occurred at a time when the defense procurement budget increased from $43 billion in 1982 to $81 billion in 1987 (or 58.7 percent in constant dollars). While DOD procurement *increased* nearly 10 percent annually between 1982 and 1987, the number of firms providing goods for those procurement dollars *declined* by more than 67 percent. The fact that the total number of manufacturing firms increased overall by about 22 percent means that firms in critical defense sectors are leaving or avoiding the defense business in favor of more profitable endeavors elsewhere.

Some defense products no longer have more than one domestic supplier, including nuclear projectiles, depth charge components, parachute recovery systems, and specialized marine vessels. The number of suppliers declined in more than 280 product groups in the last four years, an ominous trend for the near future. Here are some examples:

- More than 4,000 companies left the airframe structural components business.

- More than 600 businesses left the antifriction bearings business.

- 890 of 1,310 companies no longer sell nonpowered valves to the DOD.
- 668 of 834 establishments stopped supplying navigational instruments.

In some cases, national security was placed in jeopardy by the closure of small individual production facilities, as was the case with the 1988 shutdown of the Avtex fiber production plant - the sole source supplier of certain composite materials for missiles.

The decline of U.S. industries providing inputs to defense production has been widespread. The Logistics Management Institute has identified 50 critical industries with the poorest performance. The list includes nonmetallic mineral products, industrial equipment, electrical industry apparatus, machine tools, carbon and graphite products, fabricated structural metals, and transformers.

Anthony Harrigan, President of the U.S. Business and Industrial Council, testified recently before a House Committee also looking into the reauthorization of the Defense Production Act. In noting concern regarding the erosion of the U.S. defense industrial base, he listed such areas of weakness as bearings, shipbuilding, ammunition, spare parts, machine tools, basic metals, advanced machinery and advanced electronics.

The decline in defense-related industries has come at the expense of domestic firms. Import penetration has grown dramatically in the 1980s in 104 of 122 *critical* defense sectors. With imports growing in about one-half of the relevant industrial sectors comprising the U.S. defense industrial base, it should not be surprising that senior DOD officials are growing nervous about increasing foreign content in its $300 billion a year defense arsenal.

While the percentage of prime contracts awarded to non-U.S. companies has remained relatively constant over the past few years, there are indications that the foreign content of electronic components in subcontracts is on the rise. Foreign vendors - through their U.S. subsidiaries - are becoming more active in the U.S. military electronics marketplace. Some are teaming up with U.S. defense manufacturers to bid on Pentagon contracts. Others are going directly after U.S. contracts.

Among all the industries considered important to our nation's defense, probably none is more critical than the semiconductor industry. It is widely recognized as an industry critical to our national security and continued U.S. superiority in military systems. A declining U.S. position in semiconductors will have detrimental effects on our nation's ability to develop advanced weapons systems as well as to sustain a healthy commercial electronics industry. If the U.S. allows itself to be the second-best nation in semiconductors, can a second-best economic system be far behind?

Three years ago, a special Defense Science Board (DSB) investigation determined that the U.S. is faced with a problem of the highest national significance - the erosion of its leadership in microelectronics and the consequent decline of the technology base on which its defense relies. Its report on defense semiconductor dependency concludes, "National security requires that the U.S. remain preeminent in microelectronics (semiconductors). Without action to change present trends, the U.S. will become highly dependent on foreign sources for essential microelectronic technologies. Thus, there is a genuine threat to U.S. national security to which DOD must respond. A response to the national security issue requires a response to the decline of the U.S. microelectronics industry. U.S. emphasis must be placed on improving its ability to successfully regain leadership in microelectronics."

The declining U.S. leadership in semiconductors, however, is a much deeper and more pervasive problem than just a loss of market share to Japanese semiconductor device manufacturers. The sources of key inputs to the semiconductor industry -- electronic materials and special microfabrication equipment -- also have moved offshore. Retaining U.S. domestic sources of these items will be much more difficult than strengthening the competitive position of the semiconductor industry. Cooperation at all levels of industry and government will be required to rebuild this important industry infrastructure.

Sources of the key materials for semiconductor production have already moved offshore. The concern was highlighted recently as first Monsanto Co. and then Cincinnati Milacron Inc. announced intentions of selling their silicon operations to subsidiaries controlled by West German and Japanese companies.

This means that U.S. chipmakers will now depend on foreign suppliers for about 90 % of their silicon. Just 15 years ago, domestic producers supplied 100 % of U.S. silicon. Those sales represent the continuation of a string of purchases of American silicon wafer producers by foreign companies that will leave the U.S. without a major domestic vendor of wafers. The nation has also lost capability in several other technologies critical to advanced electronic components. Japanese companies dominate the production of ceramic packages used to house integrated circuits. They also control the market for quartz plates used to make photographic masks used in chip production.

American companies are also losing ground in the market for the sophisticated machinery used to make chips. Dataquest estimates that the American market share of wafer fabrication equipment, which etches circuits onto silicon, fell to 45% in 1987 from 62% in 1982, while Japanese companies' market share climbed to 44% from 29%. For 1988, preliminary figures indicate that the Japanese share exceeded the American share.

Nikon Corp., the Japanese camera company, was not even in the semiconductor equipment business 10 years ago. Today, it is the largest company in the industry, dominating the market for machines known as wafer steppers, which photographically reduce a chip design onto the silicon wafer.

As Japanese semiconductor companies have gained share and established manufacturing excellence, Japanese equipment manufacturers have had the benefit of working closely with the toughest and best customers in the world. In fact, many of the leading Japanese semiconductor equipment manufacturers are owned by the major semiconductor firms.

U.S. semiconductor equipment companies are barely profitable and thus are unable to invest in future products in an industry in which products change every few years as integrated circuits become more sophisticated. It also makes it difficult for companies to survive the cyclical slumps that afflict the semiconductor industry.

Several steps have been taken to deal with the problems of the semiconductor industry. Sematech, the semiconductor industry's consortium, intends to give contracts to equipment and materials suppliers to spur advanced development. I.B.M. has publicly sought a joint industry-government effort to develop equipment for x-ray lithography, a technology that could be critical to making future generations of semiconductors. The U.S. has fallen behind the Japanese in the development and production of advanced lithography systems. An

opportunity for a collaborative catch-up effort exists in excimer laser and synchrotron orbital radiation lithography equipment.

The competitive problems of the semiconductor industry also reflect issues facing a much broader range of U.S. high technology industries. As previous studies by the government and other organizations have shown, the United States is lagging foreign producers in a variety of electronic component technologies, and the gap is growing. Moreover, foreign superiority in component technologies is contributing to a declining U.S. position in electronic equipment. Only at the systems level does the United States appear to be dominant.

III. Reasons for the Decline

What are the reasons for this competitive decline in industries important to defense? First of all, increasing risk and program uncertainty, combined with the prospect of declining defense budgets, have caused many companies in the defense business to pursue other markets. Offsets and other political agreements to enable our allies to source U.S. defense programs have reduced markets available to U.S. companies. Increasing regulation and growing cost of compliance with U.S. defense acquisition requirements also have made U.S. companies look elsewhere.

Continued Congressional attention to economic issues such as large national and foreign debts or the S&L crisis causes scarce resources to be shifted away from crucial defense-related problems.

Despite the impressive gains made by the U.S. research community, U.S. industry has demonstrated difficulty transferring research breakthroughs into competitive products. Furthermore, U.S. companies tend to conduct R&D in isolation, leading to duplication of effort and generally inefficient use of research monies.

U.S. companies tend to ignore incremental productivity improvements in processes and concentrate on big breakthroughs. We face slower gains in productivity and declining productive capacity because of inadequate capital expenditures. The cost of capital for U.S. companies is far greater than for our counterparts in Japan.

We also face a growing shortage of technically educated personnel. The National Science Foundation has estimated that the U.S. will produce 400,000 fewer scientists and engineers than the country needs by the year

2000. U.S. electronics companies will find it more difficult to keep up with international competition because of the erosion of the high-quality, specialized labor force required to fuel high-technology growth.

For the nation, and the Defense Department in particular, the costs of retaining leadership in vital high technology industries such as semiconductors grow larger with time. Today, completion of a world-class factory for dynamic random access memory chips costs $350 million, 175 times as much as in 1974. By the mid-1990s, the price tag will be in the billions. Large production volumes are necessary to drive the experience curve in semiconductors and provide the levels of investment necessary to remain world-class.

Defense production alone cannot provide the volume or profitability required to support the necessary levels of investment. Government and industry must find a new formula to make the defense semiconductor business a more attractive marketplace, one that can be an important source of technological advancement for commercial applications as well.

IV. What We Must Do

Government and industry must work together to confront all issues that affect the defense of our nation. These issues include:

- An economic system that favors consumption over investment, and leaves U. S. industry at a competitive disadvantage in global capital markets.
- An educational system that fails to train people who can work in a modern factory, let alone develop the next generations of technology.
- A Defense Complex that is bogged down by mechanisms that are overly bureaucratic, complicated, slow, and wasteful.
- A global trading system that permits barriers to the free exchange of goods and services.

We need a new approach that requires the U.S. Defense Department to transform itself into a world class customer. This means a drastic reduction in cumbersome regulations and audit requirements. As outlined in the attached testimony by Christopher B. Galvin of Motorola, it would require setting very ambitious goals for quality, reliability and cycle time management improvement by the year 2000. This would force the Department of Defense and its suppliers to fix 50% to 60% of the known defense industry problems from within.

For example, quality begins with good designs. The Department of Defense must change its mechanisms for setting specifications, applying cost and compliance rules, and determining selection criteria for vendors.

The cost of poor quality has been estimated to be up to 20% of total expenditures. If this were applied to the Defense budget, it would represent up to $60 billion a year in potential savings.

Finally, we need to establish a meaningful foreign trade policy. While these hearings are not devoted to this topic, we cannot ignore the fact that the problems I have outlined have been influenced to a large degree by the absence of such a policy vis-a-vis Japan. Many fine defense contractors have attempted to confront the challenge and deny sanctuary to our competitors in Japan, but the lack of a trade policy has made our efforts difficult. That must change.

These are vital issues. Our nation's security depends on our success in achieving long-term quality goals of virtual perfection in all of our products and services. We must expect nothing less.

Thank you.

achment A

TESTIMONY BY CHRISTOPHER B. GALVIN, MOTOROLA, INC., BEFORE THE U.S. SENATE SUBCOMMITTEE ON DEFENSE INDUSTRY AND TECHNOLOGY

__ABSTRACT__: NEW APPROACH: DEMAND
THE ACHIEVEMENT OF NEAR
PERFECTION IN ALL DEPARTMENT
OF DEFENSE ACTIVITIES BY YEAR 2000

Congress can continue to pursue fixing U.S. Defense structural and operational problems program-by-program. A better approach would be to set overriding and very ambitious goals for quality, reliability and cycle time management improvement by the year 2000. This would force Department of Defense and its suppliers to fix 50% to 60% of the known defense industry problems from within.

The suggestions contained herein address improvement of the operations and performance of the U.S. Defense Department and industry.

A CHALLENGE FOR THE U.S. DEFENSE COMPLEX: ACHIEVE VIRTUAL PERFECTION BY THE YEAR 2000

Although it is still the best in the world, the U.S. Defense Complex requires significant change. In reports from the Packard Commission and Defense Science Board, some of the brightest individuals in our country have identified overly bureaucratic, complicated, slow and sometimes wasteful mechanisms to organize, staff, supply, and support United States strategic and military defense services. Needed change has not occurred in significant enough proportions.

What can cause change?

Crisis causes change. For example, the U.S. Defense Complex was never more efficient and productive than during World War II.

A peacetime concept for seeking an agent of change is being proposed by the Defense Manufacturing Board. It suggests that the U.S. Defense Department transform itself into a world class customer, thereby creating changes in systems and expectation levels that might lead the U.S. Defense industry to a dramatically higher level of performance.

In addressing industrial base deterioration, lengthy procurement cycles, potential surge capacity shortcomings, lagging manufacturing investment by defense suppliers, etc., most recommendations are designed to augment existing programs. In research and development, for example, expert reports reference the I R & D program suggesting specific changes in that one aspect. Or for factory modernization, others would call out the IMIP program and suggest additional investment or some specific modifications. Only a few of these superb reports have called for a broader or universal concept of change. Most are attempting to use the existing system to resolve the issues.

There is another alternative. It is one that requires some knowledge of management of quality techniques and a bit of courage, but no additional expenditures of the Federal Budget. The Congress could set 10-year U.S. Defense Department and Defense Industry goals for quality, reliability, and cycle time management improvement that are more ambitious than anyone has yet to imagine.

This idea is based on the premise that high goals force people to stretch beyond their existing capability and drive fundamental and structural changes in institutions. To illustrate, reflect on the role President John F. Kennedy played in motivating the United States' initiatives in space. He declared an American would land on the moon in 10 years. This came at a time when the capability of the Jet Propulsion Lab and the concept of a NASA were elementary at best when measured by such an ambition. Many knowledgeable people suggested Kennedy's goal to be unachievable at the time. History marks the results.

The objective of Congress would be to improve significantly the cost, delivery time, quality, administration and reliability of every command in the Armed Services. The same standard should be set for all operations in the Defense Department, as well as all of its suppliers. For example, every facet of

Department of Defense operations would have to perform at the following levels in the proposed time frames:

YEAR	1992	1994	1996	1998	2000
Quality **					
	3.0 σ	3.5 σ	4.0 σ	5.0 σ	6.0 σ
or - In defects per 1 million opportunities for error	66,810	22,751	6,210	233	3
Reliability					
- Improvement from 1990 levels	+30%	+30%	+30%	+30%	+30%
Cycle Time Milestones					
- Major weapons	-	-	10 years	-	7 years
- Medium	-	-	6 years	-	4 years
- Small weapons radios, etc.	-	-	4 years	-	2 years

**σ refers to standard deviation (Sigma).
Per million levels assume a ±1.5σ mean shift in process variability.

Department of Defense will have to transform itself into a world-class customer. Ambitious and overriding quality, reliability and cycle time goals represent the outside change agents. Department of Defense needs a motivator to overcome the natural self-interest and resistance to change of all levels of the Department. One should not forget that, for the most part, Defense Contractors do exactly what their customer tells them to do .

A robust quality system doesn't exist within the Defense Department. It's not because some fine Federal employees aren't trying. It's because it hasn't been invented yet. Neither Deming, Juran nor Motorola can hand Department of Defense the formula for a quality management system. You see, the management of Quality begins with identifying every possible opportunity for error -- every opportunity. Then management sets priorities as to which failure modes jeopardize a mission, for example. Only a tank commander or a logistic head knows the most feared failure modes. Eventually, all opportunities are eradicated by measuring these key variables statistically and seeking continuous improvement. But prioritization is a key. This process applies to paperwork flow, administrative processes, follow-up systems and many other non-product aspects of the Pentagon's activity. Anything one can measure, one can improve.

Some fine Department of Defense programs now being implemented complement the concepts of reduced cycle time and improved quality. The most notable are Acquisition Streamlining, Total Quality Management or TQM, and joint Department of Defense/Industry efforts to implement improvements through the Defense Manufacturing and other 'Boards.' Acquisition Streamlining is based on the premise that in buying, Department of Defense should pare its system requirements to basic functional needs and eliminate the costly 'baggage' of layers of overly prescriptive,

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6

outdated 'how to' specifications. Moreover, Streamlining seeks inputs from industry as to how to best fulfill Department of Defense functional needs. These are important components of reduced cycle time.

Significant quality improvements take place over time and occur in phases. To improve quality early on, most people do their everyday tasks a little better each day. This is good. Department of Defense's Total Quality Management initiatives are stimulating this process. Regrettably, this instinctively positive process only produces 10% or 30% improvements when 100 times improvements might be necessary and possible. To achieve such significant levels of improvement, it has to be demanded.

New and very aggressive quality objectives create a market-like force for change. They point out that current management techniques may inhibit the ability to improve. So people begin modifying the system (bureaucracy) to meet the goal. They must remove the bureaucratic barriers (certain Federal acquisition regulations, excessive record-keeping and audits, Congressional budget approval process, etc.) themselves or they often cannot achieve the improvement. By setting dynamic overview operational goals, Congress will motivate the U.S. Defense Complex to learn and change significantly from within.

Congress would host a major responsibility in supporting and controlling these overriding quality, reliability and cycle time improvement initiatives. Such a process will stimulate 10 or maybe a few hundred, specific proposals for regulatory, audit, process, and budget procedure modifications over the next 10 years. All of them will be designed to reduce the opportunity for errors, enhance reliability and streamline the bureaucracy to meet Congress' goals. Therefore, Congress itself may have to commit to reform legislation on a fast-track basis and promise that any such legislative

or regulatory change will be decided upon in no longer than 90 days. In this way, Congress must set a cycle time management goal for itself. This 90-day goal may encourage Congress to re-examine a system that now accommodates numerous committees and subcommittees with some jurisdiction over Defense matters.

To control and monitor Department of Defense's progress in meeting its biannual milestones, Congress must exercise its leadership and prerogative in at least three areas: first, the Federal Budget process to endorse Department of Defense's quality initiative; second, the Congressional appointment approval process to discipline staff appointments to those who can or are delivering Department of Defense quality and cycle time results; and third, the Congressional hearings process and year-end reports to monitor progress.

Some people have estimated the cost of quality (not doing things right the first time) to be 8-20% of total expenditures. At Motorola 8-10% is the cost of quality estimate. If a 20% cost of quality were applied to a Defense annual budget of $300 billion, this would represent $60 billion in potential savings in Federal expenditures. Perhaps more important for national security could be the knowledge that there is only a 3 part-per-million chance that a missile or projectile will misfire or that a weapons system would be delivered five years late.

Congress could change its role somewhat from its constructive operations management role (fixing Department of Defense's cost, quality, manufacturing capability, and managing by line item, etc.) to that of a kind of board of directors for Department of Defense. The role of a Board is to set broader objectives that drive operations to reach out and achieve greater overall performance. Rarely does a board of directors set out the specific day-to-day operational plans of any institution.

Congress should address other pressing Defense issues such as choice of major weapons systems, treaty enforcement and approval, and overall budget expenditures.

Quality, reliability, and total cycle time enhancements are fundamental to maintaining a viable U. S. military industrial base. Many of those industries lost to the U.S. industrial-military complex exit because they can't afford to do business with the Department of Defense, given its overly prescriptive and bureaucratic approach to conducting business. It's also true that some of these companies can't perform at world class levels of quality, reliability and cycle time. If the Department of Defense and Congress became partners in stimulating these quality enhancements throughout the defense industry, U.S. defense suppliers may catch up and surpass the Japanese by the year 2000. It's possible. After Sputnik, the U.S. caught and surpassed the Russians in space during the 1960's. In addition, other commercial institutions may re-enter U.S. military supply markets in order to participate in the management improvement processes initiated by Congress. This will drive their companies to become world class. Such transformation could be made possible by requiring the Department of Defense to engage the science of managing and eradicating all known and potential defects or errors. It's the over-reaching stimulus that would help Department of Defense become a world class customer. Seeking virtual perfection by the year 2000 will put the Department of Defense in purposeful motion.

Attachment 8

DARPA CRITICAL TECHNOLOGIES

- Semiconductors, especially 64 megabit DRAMs
- Gallium arsenide
- X-Ray and electron beam lithography
- Microprocessor and large scale integration technologies
- Supercomputers
- Computer software
- Optoelectronics
- Superconductivity
- Communications, especially secure networks, network management, and digital signal processing
- Artificial intelligence, parallel processing, and neural networks
- Cathode ray tubes, advanced display screens, and HDTV
- High-temperature ceramics
- Robotics
- Specialty steel and alloys
- Machine tools
- Polymers

Senator DIXON. Thank you very much, Mr. Galvin.

I notice that Senator Wirth has joined us. It is interesting to note that the other two of my colleagues who are here also happen to be members of the Armed Services, as is this Senator. We have this common marriage of interests in the two committees, and I note that their interest parallels mine and they are all here very attentively listening to you.

Does my friend from Colorado have any statement he would wish to make at this point?

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Very briefly, I would like to commend you, Mr. Chairman, for putting this together. We are very lucky to have not only such distinguished gentlemen as the three in front of us today, but the country to have the three of you and your companies. I know how dedicated you are.

As you go through the story about the walkie-talkie, Mr. Galvin, I hope at some point you will also put on the record the wonderful story that you have of quality control at Motorola in terms of the pager and the standard set by the Japanese. Your son told me that story the other day, and I thought it was one—you may have already done that, but I thought it was one of the best stories I have ever heard about what can be done in terms of quality control and where one—how we can achieve that. It is a very important story for all of us to have in mind.

Here is a note, Mr. Chairman. The issue that is being discussed here today is an issue that Senator Bingaman and the Subcommittee on Armed Services addressed extensively last year and the year before. Mr. Pace and Mr. Augustine were both involved in those discussions. I thought the record that was made there and the set of recommendations is very reminiscent of what we are talking about today, the same business of looking at how do we simplify this process, and I would hope that we might as part of this record refer back to that.

There were a number of seminars that were held that were very productive. I am not sure that we got any results across the river as a result of that. There were superb recommendations that came out of that set of deliberations, and just as you are saying cut 50 percent, that was one of the thoughts of that committee. Let's stop focusing attention on the 5 or 7 or 9 percent which is the profit area, where we have driven all of our attention to that concern, and we have left the cost area, and that is where we ought to be focusing our time and attention, going back to your final comment.

Thank you very much, Mr. Chairman. This is an extraordinarily important issue for us on this committee, the Banking Committee, and certainly the health of so much of American industry.

I appreciate having the opportunity to make an opening comment.

Thank you, Mr. Chairman.

Senator DIXON. I thank my colleague from Colorado.

Mr. Pace, we are delighted to have you here.

STATEMENT OF STANLEY C. PACE, CHAIRMAN AND CEO, GENERAL DYNAMICS CORP., ST. LOUIS, MO

Mr. PACE. I, too, have submitted a statement for the record, and I will summarize that statement here briefly for you this morning.

As a brief backdrop for reference purposes, when you were talking about the decline of the industry, the decline of the competitive advantage, I would like to make sure that we reference the fact that after World War II we had an overwhelming margin of competitive advantage. The fact that that overwhelming margin has been reduced over the ensuing decades because of our assistance to those countries in Europe and Japan where their economies and productive capabilities had been destroyed is fully understandable, in my view.

It is not because the United States has stood still. Rather, it is because they have advanced with our assistance. That capability today is very strong, and in some cases they have caught up with us, and in some cases that favorable margin is still there but not very great. In some cases, in my view, the productive capability of our foreign competitors has exceeded ours.

Despite the fact that we are in a hard fought, competitive battle today, it is our opinion in the industry that we do not, in general, ask for protectionism because we do believe in the free market system. We do not want a wall around the U.S. market or around our participation in it. In our view, it would be ineffective and would be folly.

However, we do request a level playing field, and I think that this is perhaps what Mr. Galvin was referring to a minute ago because a significant favorable advantage that existed after World War II has now been dissipated. We can no longer afford the luxury of continuing the concessions that our nation previously gave to our foreign competitors.

I am confident, however, that with a reasonably level playing field and with industry approaching the worldwide market, with worldwide use of equity, licenses, and teaming arrangements, we can and will compete successfully.

It is important that we compete, not hide. Competing, not hiding, is the solution.

So much for the general background. Let's talk for a moment about the defense industry sector.

I need to state that the remarks that I have just made in general apply also to the defense sector. But here I want to emphasize one element of the totality. That element is the technology and the role of technology in our national defense.

TECHNICAL SUPERIORITY

Since World War II, the Soviets have been held at bay by the technical superiority of our weapons, not because we had numerical superiority of weapons because we haven't. We had to offset their numerical superiority with our technical superiority.

Now, this technical superiority has been present because of the tremendous investments made both by our Government and by our companies, the industry.

Today, as I mentioned earlier, that margin of technical superiority in general and in the defense industry has declined and has declined appreciably. It is not that we are standing still, but it is the fact that they are catching up with us. One need only to look at the Paris Air Show and watch the MiG–29 perform and watch the Su-27 perform. They clearly have outstanding technical performance.

Today we are faced with three circumstances that may further erode our present and traditional technological superiority.

The first is the declining defense budget. Second is the reduced spending for corporate independent research and development, and, third, the so-called procurement reform initiatives.

It is clear on the first point that the defense budget will be declining in real terms for several years to come. With that as a given, fewer resources will be available to purchase the defense production systems.

The issue, in my view, is not solely production capacity, when we are discussing the industrial base, but rather it is the total appropriate resources required to produce not just weapon systems, but required to produce technically superior weapon systems.

CORPORATE INDEPENDENT RESEARCH AND DEVELOPMENT

Funding for technology based programs is particularly vulnerable in a time of tight budgets such as we are experiencing today. That leads me to one of the most important aspects that I want to review with you, the importance of the corporate independent research and development.

The corporate IR&D program has been controversial for many years, especially within Congress. IR&D allows companies to recover part of the cost of research programs initiated and funded by the company as a cost of doing business for the Department of Defense. This cost is recovered as an allowable expense in contracts with the Department of Defense, and of course the Department of Defense passes judgment on us. It judges the relevance of the IR&D work to their needs and decides how much of that cost they will allow. The remainder of that company's research and development effort is funded out of corporate earnings.

There was a major effort last year by some in the Government to reduce the independent research and development funds, and that is an indication to me that not everybody understands the true value of IR&D to our Nation.

The opposing concept to IR&D, that an all-knowing Department of Defense can simply contract for certain technology when it decides that it wants it, is absolutely shortsighted. The operative word in IR&D is the word "independent."

Most of us in the defense business would argue that IR&D is the life blood of our business. It provides the means for the industry to conduct the kind of innovative research that has built and maintained our defense technology base over these years, and it has been responsible for a majority of our new and superior weapon systems.

For example, in the case of General Dynamics, the Standard missile, the Tomahawk cruise missile, the Phalanx gun system, and the F-16 Agile Falcon would not exist had it not been for our IR&D programs.

Over the past few years, many actions have been taken under the label of procurement reform. Many of these actions have contributed to the erosion of the defense industry's technological capability. In time this erosion of our capability will contribute to the erosion of the technical superiority of our weapon systems.

I don't want to talk about all of them, but let me discuss a couple of these procurement actions.

It has become the practice within the Department of Defense to conduct the source selection process for development contracts in a way that levels the technical aspects of the competing bidders' offerings. In addition, the practice has been to use fixed price contracting for the development process. The combination of these two practices results in price being the only discriminator between bidders.

Moreover, a contract for development programs spanning 4 to 5 years on a fixed price basis constrains the technological innovation. Development work by nature is high risk. The uncertainties of the development are such that no one can precisely predict the cost of that development.

The second example is less obvious. Over recent years there has been a concerted drive within DOD to second source many major existing weapon systems which are already developed and already in production. This has resulted in annual competitive procurements between the contractor who was the initial developer and producer and the contractor selected to be the second source supplier. Since the second source supplier simply builds the weapon system, to print he has no need to maintain the additional cost burden of innovative technology skills and product development laboratories characteristic of a technically advanced industry. In fact, such costs are handicaps which keep him from winning the competitions.

The questions then are what are the long-term effects of making annual procurement decisions strictly on the basis of price competition and second sourcing many of the major defense systems on a "build to print" basis?

The answer, U.S. companies may no longer be able to afford the cost of a well-trained cadre of engineers and scientists and appropriate research laboratories vital to America's technological superiority.

However, it should be said that the industry welcomes competition, but on a product-to-product basis, or on a form, fit and function basis, instead of a "build to print" basis. The product competition has the advantage of incentivising the contractor to use product engineering, in addition to process engineering, to reduce cost, and in general, the product engineering has far greater leverage on cost than does process engineering. In addition to that, product competition and its resultant use of product engineering strengthens and enhances our technological base.

I thank you very much for your attention.

[The complete prepared statement of Stanley C. Pace follows:]

STATEMENT BY

STANLEY C. PACE

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

GENERAL DYNAMICS CORPORATION

BEFORE THE

SENATE BANKING COMMITTEE

JULY 19, 1989

Thank you for inviting me to appear before this Committee for the purpose of sharing my views on whether the competitive position of American industry is in decline relative to our major trading partners and, if so, the implications this has for our national defense.

In your letter of invitation you posed four questions. In response to these questions and the general thrust of this hearing, I want to state, as background, that after World War II the U.S. economy, technology and manufacturing had an overwhelming margin over Japan and the nations of Europe, because their economies and industrial bases had been devastated by the war. With U.S. assistance Europe and Japan have rebuilt their capabilities and during the many years since the war have substantially reduced this overwhelming margin of competitiveness and, in some cases, the margin is now in their favor.

The substantial reduction of this margin occurred not because the U.S. stood still. We did not. As you know, our technology, our economy and our productivity have grown tremendously during these forty plus years. However, we did become accustomed to our significant favorable margin of competitiveness of the 1950s and subconsciously assumed it would continue indefinitely. That illusion has been shattered and we all know that we are in a global competitive struggle that now is hard fought and in the future will continue to be hard fought.

We, in industry, generally do not ask for protectionism as we truly believe in the "free market" system. We do not want a "wall" around the U.S. market and our participation in it. That would be ineffective and folly. However, we do request a "level playing field," because the significant favorable margin we previously enjoyed is now gone or almost gone. We can no longer afford the luxury of continuing the concessions we previously gave. I'm confident that with a reasonably "level playing field" and with industry approaching the worldwide market with worldwide use of equity, licenses and teaming arrangements, we can and will compete successfully. Competing, not hiding, is the solution.

Turning now to the defense industry sector, I need to state that while my prior remarks also apply to this sector, I want to emphasize the importance that technology plays in our national defense. Since World War II the Soviet Union has been held at bay by the technical superiority of our weapons, not the quantitative superiority. This technological superiority has been the result of investments in research and development by both government and industry.

Today, the margin of American technological superiority has appreciably declined. One need only look at the aerial demonstrations of the Su-27 at the 1989 Paris Air Show to realize that. Today, we are faced with three circumstances that may further erode our technological superiority: first, a declining defense budget in real terms; second, reduced spending for corporate independent research and development (IR&D); and third, procurement reform initiatives.

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It is clear that the defense budget will be declining in real terms for some years to come. With that as a given, fewer resources will be available to develop and produce fewer defense weapon systems. So the issue becomes not solely production capacity, but the appropriate resources required to produce the technologically superior weapons we must field. Funding for technology base programs is particularly vulnerable during times of tight budgets. That leads me to one of the most important aspects that I want to review with you, the importance of corporate Independent Research and Development.

The corporate IR&D program has been controversial for many years, especially within Congress. IR&D allows companies to recover part of the cost of research programs initiated and funded by the company as a cost of doing business for the Department of Defense. The cost is recovered as an allowable expense in contracts with the Department of Defense. The Department of Defense judges the relevance of IR&D work to defense needs and decides how much of the cost can be recovered within an overall ceiling set by DOD. The remainder of the company's research and development costs are funded out of corporate profits.

Last year's effort to reduce IR&D funds is further indication that not everybody understands the true value of IR&D to our country. The concept that an all-knowing Department of Defense can simply contract for certain technology when it wants it is shortsighted. The operative word in IR&D is independent. Most of us in the defense business would argue that IR&D is the life blood of our business. It provides the means for the industry to conduct the kind of innovative research that has built and maintained our defense technology base and been responsible for a majority of new and effective weapon systems. For example, in the case of General Dynamics, the Standard Missile, the Tomahawk cruise missile, the Phalanx gun system and the F-16 Agile Falcon would not exist had it not been for our IR&D programs.

Over the past few years, many actions under the label of procurement reform have contributed to the erosion of the defense industry's technological capability. In time, they will contribute to the erosion of the technological superiority of United States weapon systems. I would like to discuss two of those actions.

It has become the practice within the Department of Defense to conduct the development source selection process in a way that levels the technical aspects of the competing bidders' offerings. In addition, the practice has been to use fixed-price contracting for the development process. The combination of these two practices results in price being the only discriminator. Moreover, a contract for development programs spanning four to five years on a fixed price basis constrains technological innovation. Development work is, by nature, high risk. The uncertainties are such that no one can precisely predict the cost of development.

The other example is less obvious. Over recent years, there has been a concerted drive within DOD to second source many major existing weapon systems already developed and in production. This has resulted in annual competitive procurements between the contractor, who was the initial developer and producer, and a contractor selected to be the second-source supplier. Since the second-source supplier simply

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"builds to print," he has no need to maintain the additional cost burden of innovative technology skills and product developmental laboratories characteristic of a technically advanced industry. Since price is now the only criterion for the annual second-source procurement, it has gradually forced the contractor who was the initial inventor and developer to reduce or eliminate the costs for engineering and research. What are the long-term effects of making annual procurement decisions strictly on the basis of price competition and second sourcing of many of the major defense systems on a "build to print" basis? U.S. companies may no longer be able to afford the cost of a well trained cadre of engineers and scientists and appropriate research laboratories vital to America's technological superiority.

However, it should be said that the industry welcomes competition on a product vs. product basis (or a form, fit and function basis) instead of a "build to print" basis. The product competition has the advantage of incentivising the contractors to use product engineering, in addition to process engineering, to reduce cost. In general, product engineering has far greater leverage on cost than does process engineering. In addition, product competition and its resultant use of product engineering strengthens and enhances our technological base.

In summary, all responsible defense contractors support effective procurement reform. However, in view of the practices and policies just described, it is suggested:

(a) that both Congress and the Department of Defense support IR&D and its present level of expenditure for long term technological superiority of our weapon systems and do not reduce IR&D for short term budgetary reasons.

(b) that the Department of Defense shorten the procurement cycle for source selection of development programs to avoid "technical leveling" of the competitor's offerings and make the selection decision based on best value to the government - not just lowest price. Technological innovation and performance capability should be considered as discriminators along with price.

(c) that the Congress support the recently announced decision by the Secretary of Defense to award high-technology development contracts on a cost type basis, in lieu of the recent practice of using fixed price types.

(d) that Congress and the Department of Defense recognise that although "build to print" second sourcing of existing products already developed and in production has the short term effect of lowering the price, the long term effect is the dramatic lowering of our defense technological base. And the latter is precisely what we absolutely need to avoid.

Thank you for your attention.

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STANLEY C. PACE

Biographical Sketch

Stanley C. Pace is Chairman of the Board and Chief Executive Officer of General Dynamics Corporation. He was elected to this position effective December 31, 1985, after serving as Vice Chairman of the Board since June 1, 1985. He had served as Vice Chairman of TRW Inc. since January 1985, had been President and Chief Operating Officer from December 1977, and been a director since 1965 when he was also elected Executive Vice President. He retired from TRW in May 1985.

Mr. Pace was born September 14, 1921. A native of Burkesville, Kentucky, he attended the University of Kentucky and the U.S. Military Academy, earning a Bachelor of Science in 1943. He received a Master of Science in Aeronautical Engineering in 1949 at the California Institute of Technology.

During World War II he served in the European theatre as a B-24 pilot and flight leader. On his 39th combat mission, his aircraft was shot down and he spent the next nine months in German hospitals and prison camps.

Following the war, Mr. Pace was stationed at Ohio's Wright-Patterson Air Force Base in a series of logistics assignments, culminating with duty as a Deputy Chief of the Procurement Division, U.S. Air Force Material Command.

In 1954 Mr. Pace joined TRW and was named Sales Manager and then Division Manager of one of the company's West Coast operations. In 1955 he was appointed Manager of the Jet Division in Cleveland and, in 1958, he was elected a Vice President and appointed General Manager of the TAPCO Group. In August 1971 he was selected to head TRW Automotive worldwide and was named Assistant President in October 1976.

Mr. Pace currently serves on the Board of Consolidated Natural Gas Company, Pittsburgh. He is a former director of TRW, Inc., Republic Steel Corporation, National City Corporation, National City Bank and The Lamson & Sessions Company.

He headed the United Way Drive in Cleveland for the year 1984, raising $44 million.

From 1978 to 1985, Mr. Pace served as Chairman of the Cleveland Foundation's Distribution Committee, which governs the Foundation and allocates its income. The Foundation's goal is to enhance the quality of life for all citizens of Greater Cleveland using funds entrusted to it.

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From 1982 to 1984 he served as Chairman of the Greater Cleveland Roundtable, a group of community leaders committed to creating jobs and improving housing, education and race and management-labor relations. He is now a member of Civic Progress in St. Louis, which is dedicated to goals similar to those of the Greater Cleveland Roundtable.

Mr. Pace has been a Director of the National Association of Manufacturers since 1973 and served as its Chairman in 1985.

Since 1981, he has been associated with the Boy Scouts of America, serving as Commissioner and President of the Greater Cleveland Council for five years and three years, respectively. He received the Silver Beaver and Silver Antelope Awards. Mr. Pace now serves on the Board of the North Central Region Boy Scouts of America.

Mr. Pace has served a three-year term with National Junior Achievement, six years as a Trustee of Judson Park, a non-profit, interdenominational retirement community, and six years as a Trustee of Denison University. He currently serves as a Trustee of Washington University. Mr. Pace joined the Chancellor's Council of the University of Missouri - St. Louis on February 11, 1988. In November, 1988, he was elected Vice Chairman of the Aerospace Industries Association (AIA) Board of Governors.

He is a member of the Society of Automotive Engineers, American Institute of Aeronautics and Astronautics, American Institute of Management and the National Aeronautic Association.

He received an Honorary Doctor of Law Degree from Maryville College in St. Louis on May 3, 1987. Mr. Pace was appointed National Chairman for United Nations Day for 1988 by President Reagan.

Mr. Pace and his wife, the former Elaine M. Cutchall, have three sons.

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January 1989

Senator **Dixon**. I thank you, Mr. Pace.

Gentlemen, if it is satisfactory, we will do a round of questioning here. The questions will be limited to 10 minutes.

Let me first ask you, Mr. Augustine. You talked about the fact that we have got to fix our defense acquisition policies in this country. I think all of us agree with what you say, and we keep groping for a way to do it.

You probably know that this Senator is the Senator that offered the amendment to the DOD reorganization bill a couple of years ago that set up the Undersecretary of Defense for Acquisition.

I thought the idea, which, after all, was in the Packard Commission report, was a good idea. I have to say that as the father of the legislation I am not at all impressed by how well it has worked so far, and that is no reflection on the two men that have held that post.

What would you say is the central solution to fixing the defense acquisition policy in this country?

Mr. **Augustine**. It is a difficult question because, frankly, there is really no one thing you can go fix. As you well know, there is such a long list. I think there are two things that stand out in my mind, though.

TURBULENCE IN ACQUISITION

One has to do with the turbulence in acquisition. We heard a great deal in the past about money that was wasted on the washer, toilet seats, those things, and even if true, the amounts were trivial. We waste huge amounts of money by starting programs, stopping programs, slowing them down, accelerating them, changing them, revising them. That is where the money is lost. That is where the efficiency is lost, and worse yet, the management of the companies is distracted, trying to keep programs alive instead of trying to keep programs running well.

So turbulence is one. If we could just get some stability. Our nation has changed its policy toward defense as a whole, toward increasing or toward decreasing budgets, 15 times since World War II. There is no stability.

The second thing comes closer to your comments. I happen to think the creation of the USDA was a very appropriate thing to do, and if it has had problems—and I think it has had, also—I think they reside in two particular areas. One is exactly what is the authority of that position. What authority does that individual have? Can that individual—can he or she direct the Secretaries of the Services with regard to, for example, fixed price contracting?

The second—and this is the second biggest point that I would raise—has to do overall with people in the process. No matter what our organization is, no matter what our policies are, if we don't have really good people, really first-rate people in the Government, people with experience in the trenches, it will be very hard for us to be successful, and so I would hope that we can continue to try to find some very talented, experienced individuals to fill those jobs.

Senator **Dixon**. Mr. Galvin, I am intrigued by one of your remarks. Your outstanding reputation as a great business leader and representative of solid conservative thought is well-known to all of us, yet I hear you and others saying from time to time that maybe the Japanese do have a better idea, where the Government works with business and maybe with academia—perhaps it was Mr. Augustine who mentioned that—perhaps a little with labor, targets certain markets, puts together plans, and so forth.

Are you saying or did you infer to some extent in your remarks that maybe we ought to be looking at some of that kind of policy from the standpoint of defense acquisition, defense policy, defense industrial base, surge capacity, and the like?

Mr. **Galvin**. If we wish to win and if we wish to sustain, the answer is "yes." Most people do not understand that the developmental system in Japan is a risk-free system. That makes it pretty easy for the investor. For the large corporation it is risk free. It is prescribed in laws like Law 17, Law 84, 1978. They are all there translated into English. They allow the government to provide X amount of money to three or four or ten nominated corporations to enter a particular business. Nobody else will go into the business. Nobody has to pay back the loans that are given if they don't succeed. They can cartelize. They will be protected as they enter that business, and as a consequence people are picking out—individual corporations in Japan by assignment, by voluntarism—are picking out niches of the new technologies, and they can proceed into those to a degree that most United States corporations, possibly up to and including an IBM, cannot afford to do incrementally. As the Japanese society is aggrandizing its competence, the little Paul Galvins of 1936 or the big Motorolas of 1990 cannot pick all of those things.

HIGH DEFINITION TELEVISION

Do you know what is happening in high definition television? The Japanese are presently spending directly on high definition television products $1 billion a year and $18 billion a year on the associated networking concepts, so that their industries will have the leading-edge competence.

As a consequence of that, as Norm Augustine said, there are all of the interrelated competencies that come out of the commercial sector and that finally are translatable into a display for a jet airplane or a very unique fitting. And they learned how to do this because the income that comes from bicycle racing taxes and tobacco all are put through the Japanese industrial bank to finance it.

You cannot expect the tens of thousands of companies that are abandoning the service of our defense needs to compete against that system.

Now, we don't want to protect against that, but we have to have an analog to it, and I respectfully suggest, as heretical as it sounds coming from a conservative, that the United States needs to have an expression of national intent on a wide variety of things that are programmable, forecastable, and still manageable by the private sector, and we must be able to sit down, the three of you and the three of us, figuratively speaking, and start to map out a system that preserves the free market motivations, that accomplishes this that the Japanese are now doing better than we are.

Senator DIXON. Mr. Pace, you talked about the resurgent developmental aspects of this whole thing, which I am sure my colleagues and I agree with completely.

How do we protect the kinds of business interests the three of you distinguished gentlemen represent in such a way that you will be encouraged to make these profoundly important investments in research and development that make us advantageously competitive in the world at large, particularly in view of the observations of Mr. Galvin as an example about the fact that other countries have a better system of working together in the various sectors to accomplish these purposes?

What can we do to protect that?

Mr. PACE. Speaking directly to the technological capability that I feel is the key element within our total competitiveness within the defense industry, I think that there are two or three things.

One is with regard to the R&D, we can maintain both in Congress and the Department of Defense a very strong positive position, recognizing the independent aspect of the R&D as opposed to a totally planned R&D concept from the Department of Defense. We need both, but we really need the IR&D. That would be helpful from the technological standpoint.

Second, I support very strongly the use of cost type contracts for development contracts. I hope that the Congress will support Secretary Cheney and Secretary Atwood in saying the development contracts in the future will be of a cost type nature unless there is an exception that is fully justified. I think that this will be a very strong action to improve the technical capability.

Third, with regard to the point that I made concerning the deterioration of the procurement process for development where the emphasis is on price, not on the technical competence of the product that is being proposed, I think that this needs to be changed so that the emphasis is not on price. We should incentivize the industry to give us the best product. Now, price has to be considered, but not price alone, and where we have these long procurement processes where it ends up with technical leveling between the bidders themselves, then the only thing left as a discriminator is the price.

Senator DIXON. Everybody can make something cheaper, I suppose.

Mr. PACE. That is right.

Senator DIXON. I hope you know, Mr. Pace, that I put in that quality amendment, which is now part of the act, and we hear you. I think your point is well-taken.

The Senator from Alabama.

Senator SHELBY. Thank you, Mr. Chairman. It is rather unique when three of us from the Armed Services Committee are here this morning and also are members of the Banking Committee dealing in areas that we cross over in both committees.

After having said that and reiterating what the chairman said, I want to focus in on the acquisition process.

We realize—most of us realize—by looking at the rules and regulations that you have to deal with, or anybody deals with, dealing with the Pentagon, I don't know how you survive. A lot of people are just walking off and looking the other way, a lot of small companies.

You three here today represent, respectively, three successful, huge companies, and all three of you do a lot of defense work. You do other work, too.

LACK OF TRUST BETWEEN PENTAGON AND CONTRACTORS

One of the problems, as all of us know, is that there is a lack of trust between the Pentagon and the defense contractors, and you can just look at the public opinion polls and see what is on the news night after night—maybe not every night—coming out of the ill winds, coming out of other things.

I believe that you do need predictability. You need something that you can depend on in business, whether you are dealing from a defense posture or not.

But how are we, working together, going to be able to bring integrity back to the system; in other words, mutual trust from across the river to your group all over America?

I think it is a real problem. I don't believe that we can do it—and the chairman of the subcommittee has alluded to it, although he is trying to reform the acquisition process totally—by legislation or regulation. That is not going to do it. It is like legislating ethics, you know.

Mr. Pace, do you want to comment?

Mr. PACE. Yes, thank you. I do want to comment on that.

I feel that that is one of the most damaging things that has occurred in the last few years, both to the industry, to the Department of Defense, and to the national defense, and, of course, to the defense budget. A lot springs from that.

I have a goal for my company and I would hope that the industry has a goal for itself, which is to stay off the front pages of the newspaper, and I think if we can stay off the front pages——

Senator DIXON. We all want that goal, Mr. Pace.

Mr. PACE. If we can stay off the front pages of the newspaper, and whatever it takes to do that, then I think that this will tend to reduce the animosity that exists not only between the Department of Defense and industry, but also between the Congress and the Department of Defense.

Senator SHELBY. But you think what the taxpayers—the American people—you know, their perception of the Pentagon acquisition process, their perception—I am speaking generally now—of the defense contractors is undermining everything that we are trying to achieve, including yourselves.

Mr. PACE. Absolutely, absolutely, and we must recognize that as a root cause. We must recognize that all three of us are players in that; that is, the industry, the Department of Defense, and the Congress. We all have a part to play in this. We got into it, all three of us, together. We've got to get out of it, all three of us, together by working cooperatively together.

Now, that is a great goal. What are the mechanics to get there?

Well, there are many things that can be proposed. I have one proposal that I have been voicing within the industry and within the Department of Defense, and that is with regard to rules and regulations. I know that this alone will not solve the problem because there is a matter of integrity in addition to that, but improve the rules and regulations, and we can help ourselves.

For years, as a member of industry, I fought with the Department of Defense to have the rules and regulations broad and general, to give flexibility to the people that were negotiating at the negotiating table to cut a deal that made sense based upon the unique aspects that pertained to that particular case. Good management right out of the management books of Harvard or anywhere else support this concept.

However, due to what has happened in the last 5 or 6 years, the severe criticism of the hammers and the wrenches and the screws, and so forth——

Senator **Shelby**. Much more than that now. The ill winds. A lot of people on both sides, people inside the Pentagon, people inside industry, are copping pleas week by week on big stuff, not just hammers and screws, you know, coffee pots.

Mr. **Pace**. That is true, but that ill wind is a matter of integrity and honesty. I am talking about what we can do with the regulations. The regulations will not address integrity and honesty, but what it can do is help. I vote in favor of simplicity and straight lines.

For instance, if we are going to play a game of tennis, I would like to know where the tennis lines are on the court before I play. Today some of the rules passed by Congress and by the DOD say, you go ahead and play the game and after the game is over we want you to sign a certificate saying every ball you hit was inside the court, but we are not going to draw the court line until later on, and then in the next 5 years we will make the judgment as to whether or not your ball was in the court and whether your certification is right and whether or not we are going to send you to jail.

Now, that is obviously an extreme description, but it is close enough and it is valid enough that we need to avoid such ambiguity. So I think we need to push on that.

Now, with regard to integrity, the ill wind thing, we as leaders of our companies need to be very up front with our people inside to make sure not only that we do things honestly, but we stay back from the edge of the rules, back from the edge of the laws. We have to do that not only as a matter of ethics, but we have to do it as a matter of practicality.

We have to get off the front pages of the newspaper, and if you crowd the regulations, if you crowd the laws, somebody is going to cross the line unintentionally. You have to increase the sensitivity of the Department of Defense and the Congress and the industry to what is acceptable to the taxpayer, and his acceptability is vital. He is the ultimate customer and our conduct has to be acceptable to him, when and if it is put on the front page of the Washington Post.

Senator **Shelby**. Central to all of it has got to be an honesty on both sides?

Mr. **Pace**. Absolutely.

Senator **Shelby**. Mr. Galvin.

Mr. **Galvin**. Yes, I am delighted that you raise the issue and put it in the context of the word "trust," a terribly powerful word. People have asked me, "Bob, your father prepared you for the business. What did he do to prepare you for the business?" And I say, "He treated me very unfairly. He trusted me!" Now I really had to measure up.

I respectfully suggest that is a word that you ought to use, and you ought to find a way of using it, and here is a methodology in general terms.

The system that we have got now is managing disquality. I am talking about quality in its most generic sense. Tim asked me if I would at least mention the word "quality."

You can take institutions. Institutions behave according to the way you put them together, and if you decide as a board of directors of this country—forgive me for using different analogies—that as a board of directors you want the defense system to become ultimately a virtually perfect system, you become a world class customer.

As my son testified before your other committee under Senator Bingaman just a few weeks ago, you will now force the system—and I am being terribly generic and general here, and it takes hours to understand this philosophy and believe it—you will start to manage a quality system instead of managing a disquality system.

And, incidentally, the cost of managing poor quality is roughly 10 to 30 percent of an institution. So if you are spending $300 million, you are wasting $50 million by managing poor quality.

Specifically, may I suggest that it be a national policy that every company in this country go for the Baldrige Award?

Immediately, the economy will start to generate better, and we will all come at a system of quality that even the Defense Department's excellent quality rules don't measure up to, and this means how we conduct ourselves, not just the quality of the product.

I think that there are lots of methodologies—if we spend a few extra minutes which you cannot do in this kind of hearing—that can change the whole way of how we get along with each other over the next 10 years and then for the next 40 years, and you are going to need a defense operation for the next 50 years, the next century. You will have one that has got quality built into it instead of the managing of nonquality.

Senator SHELBY. Mr. Augustine, I don't have much time, but I want to hear your comments.

Mr. AUGUSTINE. I would like very much to comment briefly.

I think there might be lessons to be learned from our commercial businesses that our companies and others like ours engage in. We really don't have this problem of adversarialism with our customers in our commercial businesses, and yet it is the same companies with the same basic people, and one has to ask why.

Similarly, I would point out that I suspect that our three companies employ perhaps 300,000 or 400,000 people. The defense suppliers employ over 2 million people. The last I saw there had been 19 people indicted for ill wind. That is terrible, but we must remember that there are probably 1,990,000 that are very decent and trying to do their jobs, and I hope that we don't publicly on the front page indict those people who are our employees, who are decent people trying to do the right thing.

Senator SHELBY. I am not trying to indict anybody. I am trying to focus on the issue. As you well know, some of us—and it has been mentioned two or three times—we serve on the Banking and Armed Services Committees, and we are interested, like you, in a strong industrial base, strong defense posture, predictability, but central to all of it has to be some honesty or honesty, period, in the system, whether you are dealing with private customers or with the Pentagon.

Would you agree to that?

Mr. AUGUSTINE. I would absolutely agree to that.

Senator SHELBY. My time has expired.

Senator DIXON. I thank the Senator from Alabama. I would say to my colleagues I am following a nonpartisan early bird rule, and under that rule, the Senator from Colorado is recognized.

Senator WIRTH. Thank you very much, Mr. Chairman.

This is a very distinguished panel, and I am so pleased to be able to be with you this morning. Three questions I want to ask, one on the Defense Production Act itself, and second on the kind of model that we see with SEMATECH and the potential of that with high definition television, and the other concerns the "Galvin 50 percent clean-out" goal.

First, the Defense Production Act. It is my understanding that we started with seven titles of that legislation. Three remain. Two are crucial to this discussion.

One is title III, which effectively gives the President, it gives the Secretary the authority to enter into all kinds of partnerships and arrangements.

The second title of note is title VII, the last title of the act, which allowed the Secretary to let, say, Mr. Pace and Mr. Augustine get together without fear of antitrust, and that is an important kind of clearing out the underbrush so that for the purposes of the national defense we can have more cooperative endeavors.

We are here first and foremost to look at the Defense Production Act. That is what we have the authority to do. If we don't extend it, the legislation expires and terminates in September.

I was wondering if any of you had looked at or had your legal beagles look at that legislation and had suggestions to us about what we ought to do, if anything, other than just reauthorizing the legislation. You might want to make any comment on that or answer for the record. That is the immediate chore that we are facing in the committee.

Mr. PACE. I will briefly comment.

Our people have advised that as it is written it is satisfactory to them. On the other hand, I would be happy to make a more detailed study.

Senator WIRTH. I think it would be helpful, Mr. Chairman, if we could have each witness provide comments for the record.

Senator DIXON. I think the point is well-taken. We are going to have to consider reauthorization of that bill almost immediately, and I think the Senator's point is well-taken.

Senator WIRTH. Thank you, Mr. Chairman.

The second question spins from that, and that is coming out of title III of that act was the authority that the President and the

Secretary has to encourage the kind of partnership that we saw in SEMATECH.

My question is, one, do you have a sense that SEMATECH has worked as a model that we ought to pursue and, I think you mentioned high definition television, Mr. Galvin—should we be embarking on a similar kind of a structure in the area of HDTV?

I think now we have $50 million in DARPA in the last authorization bill for high definition television. Is that adequate?

Again, it is this kind of partnership we need to explore. Some people call it an industrial strategy. Leaving that word aside, this partnership is what we see in title III.

Has SEMATECH worked? Is that the sort of thing we ought to do in HDTV? What else should we be doing if that is an important area?

Mr. **Augustine**. I would like, Mr. Chairman, to comment on SEMATECH.

SEMATECH

In my opinion, SEMATECH has worked and is a very good model, along with the NACA that I cited, for the kind of effort that we need. I think we need to focus on technology, critical technology. Certainly semiconductors would fit that description, and if I have any question about SEMATECH, it is were we too late, and I don't know the answer to that. We will find out.

But I think we have got talented people involved in it, and it was the right thing to do. It was a good example of the Government working together with industry, with academia.

Clearly, as we have heard, U.S. industry is finding that individual companies are being pitted against combinations of foreign governments and their industries, and we are not faring well, not surprisingly. You don't have to be big to have good ideas, but you have to be big to have staying power, and organizations such as SEMATECH I think help give us some of that staying power.

Anything that can be added to the bill when it expires in September that would ease the creation of technical organizations of that type I think would be very constructive.

Senator **Wirth**. We may have you look at specific language that might do that. That would be helpful.

Mr. **Augustine**. I would be happy to do that.

Senator **Wirth**. Do the others have comments?

Mr. **Galvin**. SEMATECH is an example, a model, a tactic. I think it is an excellent one. It is succeeding sufficiently and rather appealingly, and we must learn as a country to have a variety of options like that. The Japanese have been practicing these things since the 1920's. So they have had 70 years of experience at this class of thing. We are only getting at it in the last 8 years, so to speak.

So let's not be afraid to keep the experiment and the expanding of these techniques, and I am very confident that we, with private sector determination and cooperation with the public sector, can find very practical ways of SEMATECHing a lot of situations. For example, I think there is going to have to be specific support of Mr. Augustine's or Mr. Pace's company or some other company, perhaps two and three at a time, that don't necessarily even come under the rubric of a so-called SEMATECH.

We don't have to be afraid of that. These things will build America's base.

Mr. **Pace**. I have no comment. I agree with the gentleman.

Senator **Wirth**. There is the authority for us to embark upon a kind of industrial strategy in the United States which we find across the river at the Pentagon. But it seems to me it is an important endeavor for us to be working on, and the question I guess that we face, Mr. Chairman, is given this authority, given the success of SEMATECH and what we are going to be doing in high definition television, given the new consortium that is coming up on D-RAMS—I understand there is a major new one that was recently announced—how do we encourage the Department of Defense to take greater advantage of this authority that they have and to do this in a creative way.

That clearly goes to the people question that you were mentioning, Mr. Augustine. How do we get them to focus on this kind of cutting edge partnership that we see in SEMATECH?

And any ideas that you might have on how we go about springing that loose or getting that creativity flowing to do more SEMATECHS, it seems to me would be very beneficial for the country, very good for our defense industries, and very good for our competitive interests around the world.

THE GALVIN 50 PERCENT GOAL

Moving to the Galvin 50 percent goal, we had discussions last year in the Bingaman subcommittee and in your subcommittee as well, in which I remember Mr. Costello coming up and testifying in front of your subcommittee in Armed Services, and I asked him how many regulations had been cut as a result of the implementation of the Packard Commission report and the recommendations made coming out of the Bingaman study.

The response was after all of the flowing rhetoric about how important this was, the response was that in fact two had been done, and the two of those were minor regulatory changes.

We had all been working together on this for 2 years, and you remember that, Mr. Chairman, and everybody kind of thought, oh, lord, if we can't get it done with all of this attention and with Costello and with the Packard Commission and the new authority, how do we go about reaching the Galvin goal of 50 percent, much less the 90 percent goal that you said?

I don't know. What do we do on that front? How do we get at that?

If you were sitting where we are, Mr. Galvin—let me ask it this way—if you were sitting where we are—as Mr. Shelby said, you cannot legislate honesty, but how do we go about trying to get the Packard Commission put in the legislation, trying to get Costellos to understand our sense of urgency and then a mouse comes out the other end of the pipeline? How do we go about doing that?

Mr. **Galvin**. Here is a suggestion, Tim. There is a manner of legislation that in effect invokes policy. The Full Employment Act of 1946 did nothing other than to declare policy, that we shall have full employment. It happened also to set up the Council of Economic Advisers, but there flowed from that for 40 years all manner of additional things out of your Congress and/or administrations and people did something to accomplish the policy.

Why don't you pass a law that says it is the policy of the U.S. Congress to reduce Defense Department regulations and all of the things that the Congress does with the Defense Department by 50 percent over a period of the next 10 years and please report to the Congress each year your progress in accomplishing that? We don't care which rules you eliminate, but reduce 50 percent of them.

Senator **Wirth**. Not a bad idea. I may fall for that. Let's go, Mr. Chairman.

Do you have any thoughts on that, Mr. Pace. We have the Galvin model law in front of us here.

Mr. **Pace**. I think that Congress has to look at what they are requiring. The proliferation of committees over the last 10 years that work with the Department of Defense has been great. The Department of Defense reacts to their customer, which is the Congress, and to Congress' requests, laws, and oversight. Consequently, DOD regulations proliferate. Down through the DOD organization, the same reaction and regulation proliferation occurs.

I can remember that I was buying engines for the Air Force as a 29-year-old major in 1950, when Secretary Marshall asked that we establish second sources for four or five jet engines to support the Korean War build up. As a major, in 30 days, I obligated $3 billion, by selecting four or five companies to build these engines. And, I didn't ask anyone's approval. In other words, the selection of the companies and the obligation of $3 billion was not micromanaged. We had the companies going quickly. They produced the engines and they did a good job.

There was only one objection from industry, which we handled in a one 2-hour meeting. No criticism, no approvals from the high DOD levels. No colonels, no generals, no Secretaries, no Congressmen or Senators were involved.

From 1950 to now, there has been a tremendous increase in the DOD and congressional review and oversight. I only give you that anecdotal example to show that it has been done without micromanagement and since it has been done, it can be done again. But it will be very hard to cut away the review and oversight that has been built up.

Senator **Dixon**. Thank you, Mr. Pace.

May I say to the distinguished Senator from Kansas we are following an early bird rule here, and I recognize the Senator from Massachusetts.

Senator **Kerry**. Thank you very much, Mr. Chairman.

I would like to pick up, if I can, where Tim Wirth perhaps started, and I am not sure that we completed the answers completely to the questions he was raising regarding high definition television.

Mr. Galvin, in your testimony you talk about the need to have significant increase in the joint efforts on some of the cutting edge technologies, and obviously high definition has been determined by most observers to be that kind of technology with cost cutting interests of medicine, teaching, defense, as well as the commercial interests.

I wear a hat on the Commerce Committee, as a number of people here also do—Senator Kassebaum and others—and in that capacity I have introduced legislation to go beyond the current permissiveness with respect to the antitrust laws which permit collusion as to research, and my legislation attempts to now change the laws to permit development and marketing, in high definition specifically.

Let me ask you, first of all, is the protection of that umbrella adequate? Is that enough, or do we need to look to other financial and potential changes which would permit us to engage adequately in that particular enterprise?

Mr. GALVIN. The changes that you have described are immensely important, but the answer to the question is, is it sufficient to orchestrate what I will just rephrase here, a high definition video system, taking the television out of it just for a moment. It must include the high definition video objective, of course. It is so critical to the ultimate development of an information system class of product, which will have a visual as well as all other data achievabilities in it, and a consumer product component with the "television" word in it, that I think that we are going to have to look much more expansively at this situation.

It is a grand systems problem. It is not a black box product for a home. It is not a receiver to be sold through a discount house, and therefore I think that you and Commerce, et cetera, have got to continue the dialogue—and there is a lot of it going on—in an expansive way that gets everybody from the IBM's on down interested in a road map that we will accomplish in the course of the next 10 years regarding this "high definition video." That makes the whole information business in the United States a more expansive one, and frankly, sir, that is going to cost billions of dollars.

Senator KERRY. Should we be setting that road map or should we be creating structure which permits you to make the choices that will in effect define the road map?

Mr. GALVIN. You should create the atmosphere where cooperation is allowable in the private sector working cooperatively with whomever of the administration's people should work with us. Yes, there should be a very senior declaration that the Government wants this general objective to be accomplished, and there should be a great liberality of our being able to dialog among each other and cause to happen for the country, something that might, incidentally, be very advantageous to his company and not quite so advantageous to his, figuratively speaking.

Senator KERRY. I don't have any question that there will be winners and losers in this process. I mean, there is no question, and the important thing is that we avoid making that choice.

I think the pitfall of the last dialogue of the years, you know, of this decade about "industrial policy" and everything has been this ogre of us picking winners and losers. I am not suggesting that, but there will be winners and losers notwithstanding as the marketplace works its will.

But the question still comes back as you "talk" about this liberal movement within these various entities that are part of this system, does the changing of the antitrust law so as to permit that without any restraint—IBM, AT&T, Motorola can go at it because you can market and develop without restraint—hasn't that unleashed that liberal effort adequately or are you saying in terms of these billions of dollars that we are also going to have to create a financial and institutional incentive as well?

Mr. GALVIN. The answer is "as well."

Senator KERRY. What are those financial institutional incentives?

FINANCIAL INSTITUTIONAL INCENTIVES

Mr. GALVIN. There are going to have to be financing means available on a relatively risk-free basis to very large and very little players in the situation, and incidentally, sir, that sounds like it is a giveaway. If it is a soundly conceived objective, the probability is that all those financings will ultimately be repaid.

Senator KERRY. Let me ask you about that. When I was Lieutenant Governor of Massachusetts, I served as a board member of the Massachusetts Technology Development Corp., and we would actually take an equity position in risk-taking ventures at the outset where the private sector felt that they were so risky they wouldn't take that position, and once they in fact became viable or at a point where we felt they could sell the stock or go public we, by requirement, sold our equity position, and indeed many of these companies are on the board trading today and have created some 10,000 jobs, and so forth.

Is that what you are envisioning? Should there be a participation?

Mr. GALVIN. That could very well be. The equity thing—I am a little shy about that, but if it has the appropriate conditionalities to it, it may be very good.

Senator KERRY. How do you avoid the giveaway?

Mr. GALVIN. You recognize that if the American system requires that investment—I don't think you avoid the public's taking a risk—if the public wants to have a system that is competitive with the Japanese.

Senator KERRY. That raises some other issues which I think are interesting in the context of where we are going in corporate entities now in this new marketplace that we are experiencing.

Whenever we start talking about competitiveness, the conversation usually comes around to a contrast between American companies and foreign companies, but obviously that distinction is not very clear in today's world. Many foreign companies market products that are 100 percent designed and manufactured in the United States, and I know that in your case the breakthrough on the market opening in Japan with respect to the cellular telephone that you produce, Motorola produces, probably has to be discounted somewhat by the fact that it is entirely produced in Singapore.

Mr. GALVIN. Produced in Arlington Heights, IL.

Senator KERRY. None of that cellular telephone or the cellular set, none of it is produced—well, I am misinformed. That is great to hear. That is interesting.

Mr. GALVIN. We have a pager, one pager that is produced in Malaysia.

Senator KERRY. Well, carrying that to the next question that comes out of that, as we decide where the research funds go, should an American company be awarded a multimillion dollar contract for HDTV development if all of the technology is developed by a Japanese subsidiary, for instance?

Mr. **Galvin**. I don't think I would cotton to that particular example. I think you can find an awful lot of them that would be basically indigenous to the United States that would be good models.

Senator **Kerry**. But increasingly—I am not sure—we have manufacturers of American televisions entirely owned by European entities, 100 percent owned, correct? Should we then be funding that particular television manufacturer 100 percent owned by European entities?

Mr. **Galvin**. My guess is that you would find that to be hospitable. The Phillips Co., for example, has 45,000 employees in the United States. Are they American or Dutch? I think you can qualify that they are American.

We are big in France. I think we are a French company when we are in France.

So I think that you can do a thing that is very worthwhile for the United States, even though the label doesn't sound like it was born in America.

Senator **Kerry**. So we shouldn't get caught up in making those distinctions essentially, you are saying to me?

Mr. **Galvin**. But you can find a way of focusing on an American benefit.

Senator **Kerry**. Now, when Admiral Inman was here, in his testimony he cited as very significant in the current restraint on a lot of the defense-oriented industries' capacity to remain on the cutting edge is simply the cost of credit here, the cost of capital.

Do you have any comment, any of you, with respect to that and perhaps thoughts about what we should be thinking about?

Mr. **Augustine**. I would like to comment on that briefly, Senator.

Senator **Kerry**. Apparently, it is twice that of other industrialized nations against whom we are competing.

Mr. **Augustine**. The cost of capital is substantial, and within the defense industry under the procurement policies that have existed the last few years, it is very difficult even to recover your cost of capital in the business because of the policies that had been imposed.

There was a study done about 2 years ago that projected the drain on capital within the industry that was likely to happen, and that drain has actually been occurring. Our industry, the aerospace industry, increased our debt by over $5 billion in the last three years. The cost of that as it increases is where some of us will be coming up against the limits, where we are going to cut back on our R&D, which our industry has been doing, cut back on capital investment, which it has been doing, all of which affects competitiveness, the very point you are discussing.

So this all gets back into savings rates in this country and very fundamental things.

But I would suggest that the cost of capital is a very significant factor in our ability to conduct R&D and to invest in productivity.

Senator **Kerry**. I am an original cosponsor and author of the permanent R&D tax credit.

Do you think that that will have an impact with respect to that?

Mr. AUGUSTINE. I do believe it would, and particularly if it is large enough. If it is a very small amount, obviously the impact is proportionate. But I do believe that that and a tax credit for productivity investment in capital items that goes with it could also be helpful.

Senator KERRY. My time is up now, and I don't want to abuse that, but just very quickly, do both Mr. Galvin and Mr. Pace agree with that?

Mr. GALVIN. Yes.

Mr. PACE. Yes.

Senator KERRY. Thank you very much. I appreciate the time.

Thank you, Mr. Chairman.

Senator DIXON. Thank you, Senator.

The Senator from Pennsylvania.

Senator HEINZ. Thank you, Mr. Chairman.

I must say it is a delight to see three such distinguished, capable, and able individuals before the committee who have such a good knowledge, not only of the defense industry and American business practices generally, but also of the way the world works in general. I would just note that for the record and, by the way, would ask unanimous consent that my opening statement be put in the record at the appropriate point.

Senator DIXON. Without objection.

[The complete prepared statement of Senator Heinz follows:]

OPENING STATEMENT OF SENATOR JOHN HEINZ

Senator HEINZ. I would like our witnesses today to address a subject raised by former Secretary of Defense Frank Carlucci at the earlier hearing. In his testimony, Mr. Carlucci referred to the globalization of the world economy—a concept in which the United States is just one of a number of integral components in the international economic system and our producers operate and share technology throughout the world. Obviously, our economy, and in particular our industrial sector, cannot operate in isolation from the rest of the world, and equally clearly, access to foreign technology is critical to the future of our industrial base.

It seems to me, however, that globalization is only a viable concept if it is a two-way street, which is not currently the case. Technology transfer has been one way: out of the United States. Other nations have picked up our ideas and innovations and used them to become economic giants. A notable example is the case of VCR's. We invented this technology, but the Japanese developed, refined, and marketed it, and now dominates the industry. They didn't steal it. We surrendered it. While VCR's are not a key element of the defense industrial base, they and the components they use are part of the critical electronics sector, and the profits our companies could have made from their sale would have added immeasurably to their R&D spending capacity. Our failure here as well as in many other cases means yielding not only current profits but our financial ability to develop future generations of products to our competitors. A recent report by the Labor-Industry Coalition for International Trade (LICIT) highlights this disturbing trend:

The United States high-technology trade surplus fell from $31 billion in 1981 to $6 billion in 1988. From 1970 to 1987, U.S. companies' shares of the domestic market declined from 90 percent to 10 percent for color TV's, 90 percent to 1 percent for phonographs, and 100 percent to 35 percent for machining centers. VCR's, facsimile machines, liquid crystal displays, and optical and compact disc players are simply not produced by U.S. firms. It is now apparent that the absence of a strong consumer electronics production base adversely affects the entire electronics sector—including computers, semiconductors, and related leading-edge industries. The United States is also falling behind in key technologies and products of the future: X-ray lithography, superconductivity, biotechnology, manufacturing automation, HDTV and supercomputers.

This is why I oppose the FSX deal. We will be transferring critical technological know-how to our major economic competitor with limited assurance of a return knowledge flow and guaranteed return product flow that will haunt us later on.

In cases like this and the Korean Fighter Program, Government and industry must work together. We must ensure that contract negotiations with other countries contain sufficient flow-back provisions for technological innovations, both on systems we are selling and buying. Industry should keep its eyes open looking for new ideas and techniques and should be bold enough to try to incorporate them in the future, or existing systems. Moreover, industry should look for civilian applications of new technologies because it is that sector which should be the real motor of our economy.

Another example is the V–22 Osprey, a tilt-rotor aircraft for the Marines. While we are debating its future, Japan's Ishida Corp. has proposed its own plan for a tilt-rotor aircraft. In order to augment their resources for development and sales, Ishida has actively pursued a commuter airline role for the aircraft in addition to a possible military use. While I support the V–22 program, we should take note of Ishida's actions. By grasping a new technology and vigorously pursuing both civilian and military applications, they could become a major player in this field in a few years.

This may be what Mr. Carlucci meant when he talked about globalization, but it does not strike me as the way to maintain either American competitiveness generally or an industrial base in particular.

Mr. Chairman, I hope our witnesses today will address what globalization means and how it relates to efforts to enhance the position of America's defense industrial base. I know we would also welcome comments on Senator Dixon's proposed amendments to the Defense Production Act, which are an attempt to achieve precisely that enhancement. It seems to me that we are facing a very different kind of competitive world now than when this act was first written in 1950, and we need to adjust our strategies accordingly rather than rely on conventional ideas about how world trade works. So, I look forward to your new ideas as well.

There is a considerable amount of agreement among the gentlemen here that the United States has to address first a group of macroeconomic issues. Bob Galvin emphasized, quite rightly, the usual suspects in his opening statement. All of you have suggested that there needs to be, if you will, a reform of our procurement practices and some incentives to bring the best out of our industrial establishment, defense-related industries in that regard.

Mr. Augustine has suggested that there should be some institutional reform, that Congress should find a means of better focusing on these kinds of issues related to the industrial base, that the executive branch would be well-advised to follow suit, and to a certain extent there has been mention of the kinds of practices in the world trade arena that have played a role in undermining our previously uncontested preeminence in most technological areas.

To Mr. Augustine I would like to address the question that really has its background in the old saw, "You can take a horse to water, but you cannot make him drink." In the case of whether you form a select congressional committee or whether there is a Presidential level working group working under Roger Porter, who works under John Sununu, who works under the President, let me tell you what my view of that is.

Helpful but skeptical, because unless there is intellectual agreement in this country that we have got a problem and what the nature of the problem is, an agreement that I do not think we have achieved in spite of your testimony, I despair of anybody approaching these problems correctly.

My question is do you agree with the premise, do you believe that there is a vast gulf of ignorance among the thinkers in this country, thinkers in the Congress, thinkers in the administration, thinkers in the news media—that is not an oxymoron—thinkers in academia, people who are truly the opinion leaders and thinkers in this country, or do you think that people really understand the issues and that we are in firm control of our own intellectual processes?

Mr. Augustine.

Mr. AUGUSTINE. I would think, Senator, it has only been in recent years that there has even been a recognition that the problem existed in the economy as a whole, and really only in the last year or so has it been recognized that there is a problem within the defense industrial base.

Senator Bingaman's committee that investigated this subject and this hearing stand really pretty much alone in terms of creating a dialog where we can discuss such things.

Senator HEINZ. So conceptually, let's say there is a thing called intellectual consensus in the United States, of which you need pretty close to 51 percent to get anything really significant achieved. You would say that on a scale of 0 to 100 percent we are a heck of a lot closer to 0 at this point?

Mr. AUGUSTINE. I would say that, but I would qualify—I would like to make one additional comment, and that is I think within industry, interestingly, over the last couple of years we are closer to the 80 percent level. I think there is a coming together within industry as to what the problem is and what the solutions are.

Senator HEINZ. My next question is designed to ferret that out because I am not sure that is true, not that industry doesn't think it is true, and I don't know that industry is all that much further ahead than all the rest of us. There is one issue that Bob Galvin raised—our fading competitiveness versus other countries—and there was mention earlier of high definition television as a rather interesting case in point. In Bob's statement he lists a series of technologies—I don't remember all of them—and he makes the point that a lot of our supplier industries for semiconductors are going offshore and he indicates that semiconductors are an absolutely critical key technology, which I gather most of you would agree with, even though you are no longer with TRW and are more into airframes and a variety of other fascinating aerospace things, as is Mr. Augustine, but those would be pretty hard things to put together without the requisite integrated circuits and other devices.

And it is often said that one of the reasons that the Japanese have been so successful in dominating the semiconductor industry is that they recognize that they could incorporate vast quantities of integrated circuits into consumer or other products. They started with VCR's, an American invention by Ampex, which someone made the mistake of licensing, and as a result many of the Japanese semiconductor industries had this wonderful opportunity to achieve volumes of scale by selling to the various makers of VCR's huge quantities of integrated circuits.

And then comes high definition television into our picture, and it is certainly not just the prettier picture tube. It has all of these other attributes that we all have discussed plus one other that I know you all know about, which is—if the VCR was a great market for integrated circuits, the HDTV market is a fantastic market for them and a lot of other critical cutting edge technologies.

The Japanese have been investing in this for 10 years, government investment. The industry there is about to benefit from what Chalmers Johnson would describe as the virtues or the vices—depending on your point of view—of the aggressive role of a capitalist development state where the government doesn't set prices in the marketplace, but does intervene aggressively.

Consequently, Japan is doing something that we could never do in this country. They are establishing a market for high definition television sets, a big one, which will give their supply industries that leg up. It will give their HDTV makers the cost advantages that come with economies of scale.

And my question is, irrespective of whether DARPA has $30, $50, $100, $200, $500 million a year to invest in high definition television technology, why would any U.S. manufacturer ever go into HDTV if they knew that the Japanese Ministry of Post and Telegraph has decided that they are going to over time require that every hotel room in Japan have a Japanese made HDTV set which uses Japanese made circuits, high energy electronics whatever they are, and so forth, knowing that they are just going to facilitate making cheaper sets, economies of scale up and down the line that we cannot begin to match as long as the Japanese play by such a skillful set of rules.

Bob Galvin, as the consumer electronics wizard at the table, would you like to try and respond to that?

Mr. GALVIN. Yes, I will, John.

You essentially lead us to the answer, and that is that——

Senator HEINZ. If I have been too leading——

Mr. GALVIN. No, no, you have wisely led us to the answer, and that is rationally, under today's circumstances, virtually no one should be interested or willing to do that. But I believe that leadership now must recognize that the uncommon wisdom is that the system does have to change, and you spoke of the fact that people maybe haven't become alert to what the realities are. You have become alert to that. Some of the members of this panel are very alert to it. The Members of the Congress sitting at this panel are alert to it, and I think you have got to show the leadership as a group, all 435 or 535 of you, and lead us in this situation.

It doesn't seem to be coming from any place else. You can create an atmosphere where a few companies will take the risk of getting into this class of thing, and let me give you one example of a peripheral but an immensely leveraged peripheral factor that I think would, along with about five other policies, start to give a confidence level to the Zenith's, the IBM's, and/or the Motorola's to do something about this.

I believe it should be the national policy of this country declared by the administration that we should wire the country with fiber-optic broad band cable. That is a new media on which high definition video through an information network system can be accomplished in the next 10 years. The Japanese are doing that. That is what they are spending their $18 billion a year on, setting up the stage for the market for high definition video to do that. Declare the policy that would do that just like we declared policies to have railroads and telephone lines, and so on.

And I tell you, the telephone companies, if you give them allowability to go at it, whatever you call a telephone company, from AT&T on down, will say, "That is all I need, the signal you want this to happen. I will start investing my own money."

Senator HEINZ. Maybe we should try to get an appointment with Judge Green.

Mr. GALVIN. OK, it is all of those things. It is an immensely complex political system. It is an immensely complex financing system. It is an immensely complex technical and business system. But these things are all imaginable. You don't have to be a genius to see these prospects. The Japanese, ordinary people are seeing these things.

We have to have people willing to think them out and say let's go do them. Let's have the national intent to do it—and if we need to, let's finance some of it federally—wherever we can to encourage the confidence basis that the private sector would make some big moves.

Now, we invested $150 million in this business because we knew we could create a business (demonstrating the portable cellular phone). Give us confidence, and we will invest.

Senator HEINZ. Bob, my time has expired. May I ask a brief question of Bob Galvin to follow up?

Let's assume for the moment that we wired or cabled. Why wouldn't that just be a faster connection for Japanese made HDTV sets?

Mr. GALVIN. Left to itself, it could be, but let's think the whole system out. This is a systems analysis problem. These gentlemen's businesses—they made their mark. Get them encouraged to think the systems, the complexities, and then have our Federal supporters say we want you to succeed—and, incidentally, to the same degree that the other fellow has, give a protection—I will use the word. I am not afraid to use it. You are not afraid to use it, John—

we will give you a base to where you are going to get a chance to succeed in the domestic marketplace.

The Japanese practice it all the time.

USING THE "P" WORD

Senator **Heinz**. Let me take the last part of that question and throw it at Mr. Augustine and Mr. Pace.

Bob Galvin used the "P" word. [Laughter.]

Where do you stand on the "P" word?

Mr. **Pace**. In general, as I said in my statement, I feel that we must stay with the free enterprise, free trade, but I also stated that we must have a level playing field, and I think there are two ways to work the Japanese problem. One is the one that Bob has been mentioning earlier this morning as to maybe duplicate or by analogy do something similar in the United States to what they are doing.

Senator **Heinz**. That is the "P" word.

Mr. **Pace**. No, but the second is——

Senator **Heinz**. Yes, it is. We don't have time for this argument. Senator Kassebaum is next.

Mr. **Pace**. But my first point is that I think that you can have Federal financing, you can do these other types of things, and the second point is that you can block their entry into this market if they are doing some things that we do not permit ourselves here to do.

Senator **Heinz**. Mr. Augustine.

Mr. **Augustine**. I will be brief.

I believe strongly we should work diligently toward creating a free market across geopolitical boundaries. I think that protectionism is an anathema to that, but I also believe that protectionism is a tool, a weapon of enforcement, and it should be used for that purpose in a very limited fashion.

Senator **Heinz**. Thank you, gentlemen. My time has expired.

Mr. **Augustine**. I will use the word, too.

Senator **Kassebaum**. Senator Heinz, he said in a "limited fashion."

Senator **Heinz**. Yes. Just so nobody misunderstands, I think the real problem we have is defining a strategy for dealing with Japan. If we can get a level playing field and free trade, I would be all for it, but a level playing field assumes that you have two teams on the field playing by the same set of rules.

Mr. **Pace**. That is true.

Senator **Heinz**. My view is we are out there playing a very spirited game of badminton with our little tennis shoes and the Japanese are playing NFL football in pads and helmets and cleats and we are getting stepped on. They have not decided to play the game according to the rules. So the level playing field is just so much fanciful thinking because it doesn't apply at this point, the economic competition between our two countries.

Mr. **Pace**. That is how you get the level playing field, by either putting the pads on us or taking the pads off them. That is part of the definition of the level playing field.

Senator **Heinz**. That is right. Thank you, Stan.

Senator **Kassebaum**. First, my apologies for not hearing the statements of the witnesses. I had to be in another committee. I have tried to do a little catch-up, but I would like to work off Mr. Galvin. You said "think the systems through."

I think really that is a very important statement, and maybe one reason that we have such a hard time in giving the time necessary and the efforts is that we don't have an atmosphere today that permits that.

And I understand, Mr. Augustine, that you mentioned that when a company announced a major R&D spending program that the—a lot of the stock was dumped on the market because investors were fearing that the dividends would—the quarterly dividends would not be as high.

THE IMPORTANCE OF R&D SPENDING

I think this is a real problem, and I would like to ask you, any three of you, how do we get institutional investors to appreciate the importance of R&D spending?

And I would also say the point necessary for applied technology. It takes time, it takes perhaps reduced dividends. Should we address takeovers? And then I think it makes a company more ripe for takeover. Should we address from here takeovers in general or specifically institutional investors?

I think all of us have had some reluctance to address it from here, but how do we change the Draconian short-term orientation of both corporate managers and corporate investors?

Mr. **Augustine**. Senator Kassebaum, if I might, I would like to address that.

The instance I described was quite a lesson to us. Some years ago, as I said, we decided to pursue some R&D opportunities. We thought it was a great, exciting event, and our stock plummeted. We happened at that time to have been in solid enough condition. We had the courage of our convictions. We stuck with it, and I think today it is viewed as a smart move.

Had we had a takeover artist standing on our doorstep, I suspect we would not have had that courage. So I think your point about the hostile takeover impact is one worthy of thought.

There are things that I think we can do to help us take a longer term interest. Most of our companies at this table on the average turn over our ownership totally between every year to two years. Our total stockholder base, on the average, turns over in the case of our company about once a year, which doesn't encourage management to take a very long-term perspective.

One could consider such things as a tax on capital gains based on how long you held the asset you sold. So if you made a hostile offer, collected green mail, and left 3 weeks later, I would encourage a tax that was maybe 120 percent. On the other hand, if you held the asset for several years, I would encourage a very, very trivial tax. I think something like that would help management take a longer term perspective and could be useful.

Mr. **Pace**. I support what Norm said. I think that those are good ideas, and I believe that we have to look at the incentives that pertain to the different organizations. You have the incentives of the raiders. You have the incentives of the institutional investors, and that passes back down, and the companies have to look at what happens to their stock by various actions.

One thing that a company can do, which is what we have done to a certain extent in the last 3 or 4 years, is ignore the price of the stock to the first approximation and go ahead and make the investments that we think are right for the future of our company, for the future of our employees, and eventually for the future of the shareholders.

I think that the motivation has always been short term on Wall Street—and I can understand why it is. It is increasingly short term because of the raiders. The raiders have amplified the problem, and I think that there is some legislation—and I will not try to be specific on it this morning—but I think that there is some legislation that should be passed, perhaps in the way of taxes or perhaps in other ways, to control the short-term aspects of what they are doing to this country.

Senator KASSEBAUM. Mr. Galvin, in your statement you touched on something which again I think is very important, and that is education, and you said that we face a shortage of technically educated personnel, and the National Science Foundation had estimated that we would have some 400,000 fewer students.

I think this for the long run is one of the biggest problems that we face. I don't know if you have any solutions. You didn't propose any here. Maybe it is just that we need to recognize what is happening.

I think we need to demand more of our students. It seems to me we need to work harder on applied academics, particularly in the field of vocational technical education, where I think rather than students going there just because they may not have any place else to go, we ought to enhance the advantages and the professionalism of a vocational technical education.

I don't know if you have any other suggestions from what you see in your workforce.

Mr. GALVIN. I commend your understanding and your generic approach to the resolution of the issue. I would only just add one little fillip to the whole situation, and that is that those of us in the private sector have to recognize that there is an immense amount of remedial—and I don't mean learning how to speak English. I am talking about engineers learning how to design experiments. It is that range, all the way from the modest to the sophisticated—there is an immense amount of remedial education that we in the private sector have to afford for ourselves. We have to have the courage to put it on our budgets, to spend the money, or at least to cause the cash to be revolving on our P&L statements.

Incidentally, it will not cost us a penny because our people will end up being much better, and there is an awful lot of private education that has to be done. I don't mean private schools, and companies like ours have to do immensely more to help bring our people, who are excellent people, up to snuff.

But all of the other things you alluded to are things that must be addressed much more aggressively.

REGULATION IS STRANGLING INNOVATION

Senator **Kassebaum**. Mr. Pace, I just would like to—earlier you said, I believe, that regulation is strangling innovation, or somebody said it, but you gave an example that I think certainly is very true, and I am sure, as was said, if we could end 50 percent of it tomorrow we would like to in many ways.

The trouble is when you get down to the fine line of determining what 50 percent to eliminate, then it becomes more difficult, but I have read blue ribbon commission reports regarding the Department of Defense going back at least to President Eisenhower which have recommended, just as you well know, many of these steps, means of reducing some of the regulation, means of having better procurement procedures, and we have had a very hard time following it or enforcing them, implementing them.

Do you have any suggestions of how we can perhaps stick with it long enough to put something in place?

Mr. **Pace**. Well, on the length of time I agree with you. We hope that Secretary Cheney and Secretary Atwood are with us for some period of time because I think they are properly motivated to do this, and if they have the time they would be very helpful.

As I mentioned earlier, I think as we were talking by analogy, we were talking about the short-term aspect of business on their earnings and how that has been incentivised down through the chain. In a similar way, I think the Department of Defense has been incentivised with the oversight that the Congress is putting on them. They in turn create staffs and oversight.

Every time there is a wrench or a hammer type of problem, the regulations expand—if not the regulations, the practices.

So I do feel that we need a great simplification of this process that we have, and I think that it can be done. It just takes a dedication to do it, and I think it is doable. It is a major, massive thing to do, but it has to be done.

For instance, it is the bureaucracy that has grown, as I gave in the example a few minutes ago, from 1950 to now. Were you here when I mentioned that?

Senator **Kassebaum**. Yes.

Mr. **Pace**. There is no way that can be done today in the bureaucracy through the checks and balances, the oversight, and all of the staffs that have to review that type of decision. You would not get that done in 30 days.

Senator **Kassebaum**. I so agree. We do micromanage here, I know, too much. I have been a guilty party and I am sure at times done that myself, although the regulations that are most cumbersome were not drawn up due to the guidelines here. Some of them I am sure no one really knows where they came from.

Mr. **Pace**. But some of them are by law, to be very frank.

The Data Procurement Integrity law, which is just going into effect now, it is a very difficult law. It is a very nebulous law. The regulations are very nebulous, and it has tremendous impact on the industry.

So some of them do come from here, but it is true it is not only the laws, but it is also the regulations that are used to implement them, and there is a feeling, as always in the bureaucratic process, amplify the regulations to make sure I have thought of everything that could happen and to have an excuse—to have an answer for it, and that is not, in my view, the way to go.

Senator **Kassebaum**. So often, as you know, here we pass the law without thinking through the implications of the regulations to implement the law that we passed. That is where I think we should have more vigilant oversight here.

We found that out with section 89.

Mr. **Pace**. That is true.

Senator **Kassebaum**. When no one really recognized what we had done until they started to implement the regulations, and it is a real problem.

And I would just like to put in a plug, Mr. Chairman—my time is up—for something that I think is important, and that is committee reform here in Congress, and I would like to combine the authorizing and appropriating committees into one committee so that you have an Armed Services Committee that both appropriates and authorizes and we have a Foreign Relations Committee that both appropriates and authorizes, so that you don't have these committees that are duplicative.

The **Chairman** [presiding]. I am sure the Appropriations Committee will think that is a great idea.

Senator **Kassebaum**. That seems to be where it is held up because it would phase out the Appropriations Committee, but I am willing to do it either way. That is not the point necessarily. I just think that it would help us in the bureaucracy of it all.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Kassebaum.

I have been here long enough in the Congress, 23 years now, that I was here prior to the development of the Budget Committee, and so there was a time when we of course had just the authorizing and appropriation committees and the inherent conflicts that that creates.

But now with a Budget Committee created in addition to that, in effect we now go through, if you will, three rounds of separate discussions with different colleagues. We get the advantages of different vantage points and checks and balances, and what have you, but in terms of sort of Swiss watch or American watch efficiency, I am not sure that it yields that outcome. It does take longer and there is more conflict after that we have to resolve when you have it split in different places.

If I may, gentlemen, let me say to you that I am serving at the present time as the chairman of the conference on the savings and loan issue, and we are working mightily to try to get that done. So I have necessarily had to be involved in that this morning and was not able to be here, and I want to thank Senator Dixon for his chairing of the committee's session today.

I want to stress to you how important I feel your testimony is today and the general subject that we are on and the question of the reauthorization of the Defense Production Act, which has to happen this year, and the whole issue of how we are doing in terms of the fundamental structure of our economy and the speed with which technology is going forward and our global position. I want to raise three or four points with you on this along those lines.

As you, I am sure, know, this was the second hearing that we have scheduled on this subject. The first hearing we had present Frank Carlucci, Adm. Bobby Inman, and Mr. Robert Costello, Under Secretary of Defense, whom you all know, to sort of set a framework from a more public policy point of view in terms of how we look at this question of not just defense readiness and our ability to mobilize in an emergency type situation, but how are we doing, how our strategic trend lines look in terms of our ability to really be state of the art in the areas where we need to be for defense reasons and for other strategic reasons that bear on that.

I don't know if you have had a chance to read their testimony, but I want to urge you to do so if you have not.

Mr. Pace, you have had a chance to. It is still in the process. We have it typed out from the stenographic notes. We don't have it in a bound volume, but I would urge you to have your staffs get that for you and take a look at it because it is a very thoughtful discussion and it will be along the lines of many of the thoughts that you have made today.

But I would say that they have given us a very strong sense of urgency about the need to make some major adjustments in how we extrude national strategy as it relates to these kinds of questions. When they were asked to put it on some kind of a relative scale in terms of the sense of urgency that they felt, they all said that they felt a very keen sense of urgency—my word, not theirs—but you can read what they had to say themselves—and we really didn't have any more time to waste.

We need to figure out how to think this problem through in a larger way. We have got to figure out who goes around the table or do we need multiple tables, or how do we even collect ourselves as a country to think about where we are in some of these major problems. Whether it is leveling the playing field or figuring out how we wire the country if that becomes a critically defined goal for the country, or what have you, as you have said, Mr. Galvin.

And once we got past the very strong sense of urgency that they have all developed from their separate perspectives. We had a very tough time in going to the next step, and that is what is the process by which we look at this problem and debate it. Bringine out of it some decision choices and some options for ourselves and deciding what it is we are going to do. Not that the central government is going to do because nobody wants that to be the kind of central planning process that we have.

But how does the private sector, business and labor, how does government, how do citizens, how do scholars and others who would necessarily be part of that kind of a discussion, how do we find a workable way in which to collect America around a table and think it through and decide what we want to do and then do it, see that it happens and that everybody has a part to play and the parts get played in the right order, in the right sequence, and so forth.

When we got to that part of the discussion, we didn't make a lot of progress. We had a very good problem definition in a sense, up to a point. Then the question was how do we go about really working our way through it and in an orderly way, and then we don't seem to have a good decisionmaking model that we can talk about as a way to do it.

And I found that disturbing, and I don't know whether you fellows today have in your earlier testimony talked about or if you have some ideas to suggest here. I am going to ask you that question in a little bit, but I want to put a little bit more of a framework with it before I do.

I want to share with you a chart that I shared with the other three witnesses that I spoke about. This is a chart that really depicts our debtor nation problem as it has developed just since 1977.

You have all been on the scene in major capacities. You are in this global economy and you understand those dynamics very well.

But it is interesting if you look at this chart where you have got a balance here where we were—that divides us between being a creditor nation or a debtor nation. You can see from the blue zone that as recently as 1984 we were still a creditor nation, and, interestingly, we had been going all the way back to 1914, through the Depression, world war, and other things. We managed to be in a very strong financial position internationally.

We crossed that debtor nation line, and we have been coming down that curve that you see through 1986, which is here, and then I have the quarterly add-ons through 1987 and 1988, but it has been a stunning change in national financial circumstance vis-a-vis the rest of the world, and you are working at trend line data every day to manage these big, complicated companies that you all run. But when you think about what must be going on to take the nation from this point in roughly 1982 to this point down here at the end of 1988—and this is a trend line we are riding—it is an incredible trend line in that short space of time.

I had been a financial analyst by training. I used to work for IBM. You seldom see a business chart that would show that kind of a rate of change on anything. If you are going to see one, you would like to see it—with a drop in defect rate on a production line, you would be happy to see this kind of a chart.

But it is a stunning change in circumstance, and it is unprecedented. We have passed every other nation on the debtor nation list. We are adding international debt at the rate of a billion dollars every 3 days.

We had Corrigan from the Federal Reserve Board seated where you were last week, Mr. Augustine. Their official estimates are that by 1992 we are going to owe the rest of the world $1 trillion net. In other words, that is where this trend line is taking us.

The only trend line that I have seen—the only thing I have seen recently that reminds me of that, there was a midair collision out in California where an Air Mexico plane collided with another plane. It sheared off a wing. It was coming down. An amateur photographer got a picture of it. It was coming down just about at this rate of descent, and it reminds me of that. It is like an airplane with the wings off.

I think this is a very powerful illustration of a set of problems. It is not one or two things. It is a whole ball of things that are—and it marks the end of the postwar period where a lot of other things around the world kept us in a pretty good relative position. But now the game is fundamentally changed, and I think it is an epic change.

Now, I take the time to say that because you are all in the defense business. I don't know what Motorola's defense percentage would be. Would it be at least half?

Mr. **Galvin**. 10 percent.

The **Chairman**. You are principally nondefense, some defense, the other two companies principally defense companies.

But in the case of your two firms, you obviously have to rely on public spending because these are public assets to maintain a national defense, and we all chip in. In fact, Motorola chips in to pay its part, even though it is only 10 percent, to supply in that area.

Our ability to sustain our commitments, whether they are public spending—defense spending, health care, anything that is in the federal budget—or anything that is in the private spending category—private investment, individual personal investment, sending kids to college, buying homes, whatever it happens to be—we have to finance our whole standard of living off of our aggregate economic performance, and when I look at trend lines like this—and there are others.

The Federal budget deficit is just as bad. You take out the phony bookkeeping on social security reserves; it will stand your hair on end, too.

EDUCATION

High school dropout rate in Japan of 2 percent. It is 24 percent in the United States. So we have to go out in our society and find in the 75 percent, at least through the high school education level, the skilled workers at all levels that are going to produce the income for themselves and the country that we have got to have.

So we have had some major, major problems here. I think that the urgency of the problem in getting it turned around so that we can sustain our standard of living, our public standard of living for things like defense outlays, private standard of living for things that we all need to have each day, requires us to make the adjustments to get off of those kinds of devastating trend lines.

Now, the question is how do we do that? How do we even capture the debate so that we get it in a form that creates enough of a sense of urgency that we decide that that is what we want to talk about and what we want to focus on?

You will see in reading the testimony of Carlucci, Costello, and Inman that they really have now developed a very accelerated level of concern about this. They were very frank in saying it the other day, franker than I have ever seen on the public record, as was, interestingly, the man who heads the New York Federal Reserve Board that I mentioned, who was two days later on another subject but made the same kind of an observation.

And I would like to ask you this. You are all busy. You are running complicated companies. You are tough enough to do that in today's environment, hostile takeovers and everything else going on.

How do we collect ourselves as a nation now on a real time basis to address these kinds of questions, think about what it is we need to do in terms of things that might lower the cost of capital, increase productivity, bring down education dropout rates, drive up national output rates, speed up technological development? How do we do this? Do we just do it with hit and miss hearings like this and hope that a little something happens out of it? What is the organized framework that has to be done here?

If you were President today, what would you do? Would you do anything differently than we are now doing just to even organize some kind of an effort to try to crack this puzzle open?

I would really like your thinking on it. Mr. Galvin, why don't you tell me what your thoughts are?

Mr. GALVIN. You raise the most fundamental questions that cannot be answered, of course, in just a few moments. But let me deign to come right to what I think is the heart of the issue.

Society is a grand and dynamic system, a system that is composed of subsystems. Our system is grand because it is large and complex, and it is dynamic because it is ever changing. The subsystems are agriculture and government and military, and so on, but there is only one that creates wealth—business—and you started this with an economic display.

I respectfully suggest the following process might yield a part of the answer, that you who are the leaders here cause the leadership in Washington, whatever it is—the President is clearly the premier leader—to ask that a selective group of businessmen—not labor, not government—a selective group of businessmen convene and talk about the business road map of America, the objective of the road map ultimately being how business can create more wealth—and I mean that in its most generic sense, not making the three of us rich—creating wealth that allows the affordability of the Republic.

Maybe we can't come to a sufficient consensus, but let us attempt to look at that consolidated problem that you have very skillfully begun to draw and then maybe listen to us and then maybe trust us, that you should get behind some of those things that we suggest.

There is a suggestion.

The CHAIRMAN. Mr. Augustine.

Mr. AUGUSTINE. That indeed is a very different question. I would share the view that was expressed at the last hearing, that among the most fundamental problems America faces is the question of competitiveness, of which defense is a subset, an important subset.

At the risk of oversimplifying, I suspect the reason your chart shows we are becoming a debtor nation is that we buy more abroad than we sell abroad. The reason we buy more abroad, in my judgment, is that our competitors from abroad have organized themselves, they have created a set of rules, if you will, by which they are going to behave in the marketplace which are different from the constraints that we have placed on ourselves.

It includes things like antitrust and a whole host of things, the cost of capital, and until we sit down and come up with a strategy of our own as a nation, I think we will continue to let them pick the markets that they want us to be in.

Japan has chosen to be in the semiconductor manufacturing industry, the semiconductor equipment industry. They have chosen to be in the automobile industry, and we are being left with exporting lumber and beef and fish, and they are making the choices.

China has decided it wants to be in the commercial launch vehicle business. They sell at one-fourth of what we can build a launch vehicle for.

We need to get together collectively and decide what industries we want to be in.

Now, it is relatively easy to do in the Defense Department because I think the Defense Department has the right to sit down and say these are the industries that are important to us and to support them, semiconductors being an example.

For the Nation as a whole, I don't find it attractive for the Government to sit down and say these are the industries that America will be in. But the dilemma we have is that we have never faced this problem. We always let the market forces take care of the problem for us, and they are not taking care of it anymore.

I think Mr. Galvin's idea is a very sensible one. I would add an amendment to it, that somehow we have to get a group from the Congress and a group from the administration to sit down with business and with labor and with academia and put together some kind of a road map, not a central economy. The Russians have tried that. That doesn't work.

The CHAIRMAN. That is sort of a straw man. I don't know anybody in our society that is serious that is suggesting that.

Mr. AUGUSTINE. No, I don't know any either.

The CHAIRMAN. But some would debunk any effort on the theory that if you do anything, you end up with government commissars deciding how many brown shoes and how many black shoes. That is not what we are talking about.

Mr. AUGUSTINE. We are not talking about a centrally managed economy. The Russians are trying it. It doesn't work. We are talking about a central strategy. The Japanese tried it, and it does work.

The CHAIRMAN. I think that is a very important differentiation. I am making notes as you are speaking.

Mr. Pace, I would like to hear your thoughts.

Mr. PACE. Very briefly, I think the gentlemen have approached it on two different elements, and I would like to approach it on still a third.

I don't think that we have in the American public a full recognition of the seriousness of the problem. I was talking with Senator Kassebaum with regard to how these incentives flow down. If there is no recognition in the public of the problem or the seriousness of the problem, then it is very hard for the Government, for the Congress or the Government to do anything about it because the people won't pay the price for correction, because there is always a price for everything.

The CHAIRMAN. Right.

Mr. PACE. So we have to do a job of—I hate to use the word "educating"—but informing the public of the problem.

Take the problem of education, which is an inherent part of this, one of the key elements. What we have in the education system is the result of how society views it. We have the different elements of society. We have the local school district that is not interested in increasing the taxes because the citizens are retired and their children are already gone, very self-serving type of thing. We need to look at those incentives in the education to try to get a broader structure for education. We need to have the people recognize its importance, and this is again through education and information training.

Too often in our system of government we take the easy out, the short-term way is to blame someone else. Business has been very strong over the years since World War II and has been the world leader. It was so strong that there was a perception that they could absorb any hits that the Government or anyone could give them, any hits that the Japanese could give them, any hits that the Europeans could give them. We have found now that business is on its knees. They have taken enough governmental hits. They have taken enough Japanese hits. They have taken enough European hits that we now are really head to head in our hard fought battle.

I just read the other day that the House was coming up with a tax bill, and the little phrase was "Most of it will come out of business."

I don't know the details of that, but my point is——

The CHAIRMAN. They paid for the last tax bill.

Mr. PACE. This is the situation. I don't know that that tax will be significant. It may not be major but it displays an attitude. Congress and the Department of Defense have assumed that business is a well that is bottomless. They can just go and go and take more water out of the well. I agree with your feeling of urgency. There is not much water left.

We have to be able to face those circumstances and tell the public that we have to make these hard choices. Dodging the issue is not the way, whether we are talking about helping business or whether we are talking about getting tough with our foreign competitors. As Senator Heinz said, they don't have the same uniform on that we do. We have to put on their uniform or they have to put on ours.

We have the largest market in the world and so we have tremendous leverage with other nations. All we have to do is use the leverage in a negotiating vein, and I think we are starting to do that.

I think it is a question of educating the people first. We have to do that, or we cannot get it done. Also, you are not going to do it by tweaking the margins of these different things. You have to be very drastic.

Mr. GALVIN. Excuse the interruption, sir. I am embarrassed to say that I have to leave at this point in order to get to an airplane in order to do a terribly important duty.

The CHAIRMAN. I understand.

Mr. GALVIN. My apologies to you, sir, and my panelists. May I be excused?

The CHAIRMAN. Yes. I understand and we appreciate your being here, and that happens to us as well.

Let me just pursue that just another minute or two here, Mr. Pace. I appreciate the comment that you made, that idea of don't worry, be happy. I am sure you have heard it, and there is this whole sort of cultural feeling around that idea that don't worry, be happy. The problems are either self-correcting or they don't amount to much, and if we just kind of roll along into the future, everything will be fine and we don't need anybody sort of raining on the parade. All we have to do is not worry and enjoy things as they are.

I am not getting that sense from what you are saying. I am getting the sense from what you are saying that the time is running out. It is a major sort of epic sized problem. That is the word I have been using. This has to be reconciled very quickly.

I will also add the comment. Where I think that we may even lose the chance to make some of the corrections that may be open to us today, we can squander options that are open today if we put them off and then reach for them 4 or 5 years from now. They may not be there in the same ways.

Is that about right, Mr. Augustine?

Mr. AUGUSTINE. I absolutely would agree with you. I think the problem is very serious. I also think there is no fundamental reason why it can't be solved. We often compare ourselves with Japan. Japan, in my mind, by and large, is not doing anything terribly wrong. They are just using a set of rules that they chose to set up just as we chose to set up a different set of rules. Their rules are working better than ours at the moment.

If you look at the fundamentals, you compare ourselves with Japan, we have more people, we have more natural resources. We have got a better higher educational system, university level. We don't begin to import the amount of raw materials. We have a huge market here at home. There is no reason, other than the structural reasons that we have chosen to impose, that we cannot compete in the world.

The CHAIRMAN. Mr. Pace.

Mr. PACE. Just one thought. In discussing the level playing field with Senator Heinz and now recently with you, I do not mean to cast any stones toward Japan or the European friends and allies and competitors. I think rather that they are working and playing as hard as they know how to play, and it is up to us to play just as hard in whatever form and format we choose. But we cannot be—in my view, we cannot be unduly critical of them. They are playing according to their rules. We need to get the rules modified or equalized.

The CHAIRMAN. You made very important statements here today, and this puts it on the public record, and you are in a sense communicating that view to the Congress—to this committee but through this committee to all of our colleagues.

When you have the opportunity to see the President, do you say the same things to the President?

I assume you do. I am not presuming otherwise.

Mr. PACE. Right.

The CHAIRMAN. And are you driving home the sense of urgency that you feel?

I know sometimes it is a little tough when you see the head of our government because it is usually in a setting that is designed for a purpose. It is not necessarily conducive to saying—tugging him on the sleeve and saying, by the way, look, we really have got to get moving with a new look at national economic strategy here.

But is your sense of urgency such that when you have those opportunities you are taking them for that purpose in order to make sure that you are alerting him as well to your feeling?

Are you able to do that, Mr. Augustine?

Mr. AUGUSTINE. We rarely miss an opportunity to convey this concern, be it to you or the public or others or to the President. I think we strongly feel it.

Mr. PACE. What I have said here this morning I have said many times before in other fora. I would have to say that I do not remember expressing these thoughts directly to the President. Such opportunities are very rare, and usually they are on a specific subject.

But I have been straightforward with this to the Secretary level of the Cabinet and to others.

The CHAIRMAN. Can I make a suggestion to you? And I happen to have had a long friendship with George Bush. We came to the Congress together in 1966. We in fact were in the same party at that time. I have great personal regard for him, and he has obviously shown that he intends to be an activist President. He is up on the job early each day. He is busy all day, and he works late into the evening, and that is a good sign.

I am going to do all I can to try to lift the sense of urgency within the Congress, not just on the Banking Committee, where we have certain ways in which we can now push these issues forward, but also I serve on the Finance Committee and we are doing so there.

As you know, the trade bill has certain aspects that are designed to deal specifically with the level playing field issue. The Super 301 procedure was something that Senator Danforth and I wrote together and put it into the bill. It is not perfect, but it is an effort to try to help in that respect.

So I can assure you that I will do, within the scope of what this committee and I can do, everything that I can think of to do to elevate this debate. Get it into tighter focus, and figure out how we move it ahead so we are not just spinning our wheels and trying to get some things done.

I think it would be useful for a group of CEO's in the country who are in strategic industries and who are really up against the international competitiveness pressure in defense activities and high technology consumer activities, as Mr. Galvin would represent and others would, maybe a group of you, 8, 10, 12, 15, whatever—somebody else would have to decide that.

If there is a collective sense of urgency among CEO's who are really operating at the highest level of advanced technology and international competition and if you all shared that new sense of urgency and that we need to find some new ways to think about crafting national strategy that enables us to make some adjustments and be able to make a surge in national output, I would suggest to you that you think about asking for a meeting, not necessarily with a lot of fanfare, but asking to go in for the purpose of discussing that with the President and his top people.

This is a new administration, and I am not sure that they have yet set all of their policy direction as to where they are going to put their blue chip emphasis. I think it is entirely possible that if they were given a persuasive argument by a group of top level CEO's that are out having to knock heads at the international arena each day who said, look, we have got to make some major adjustments for the economic future of this country and here are some of the things that we see and some of the ideas that we would like to sort of put the spotlight on, I think that would have a tremendous effect.

I think I know George Bush well enough to know that I think he—that would be a very important expression to him. I think he would listen to it. I think he would think about it. I think he would weigh it. I think his people would.

And there might be an opportunity to say in a focused way what otherwise doesn't get said in just kind of the—you know, the happenstance kinds of meetings where they are not set up for that purpose and people tend to talk about the ball scores and the weather rather than whether we need to really sort of zero in on this.

I would like to suggest that you think about that. I have talked with a number of other people like yourselves, and certainly the automobile business is an international global business headquartered in my State. I am quite familiar with the people who run those companies. But I think it may be time for a group like yourselves to collect itself and go in and basically in a constructive way say "Don't worry, be happy" really isn't the formula. Not to presume that they think it is but, you know, look, it is really we are closer to D-Day in terms of some real Team America effort that is going to have to be devised and put into place and we would like to talk to you about it, and I think that might be a way to help really get some focus going.

It happens that the nature—Nancy Kassebaum talked about how many times we take a cut at the defense budget issues. We take it in the authorizing committee, we take it in the appropriation committee, we do it in the House and in the Senate.

It is the whole nature of our system to divide power so that power cannot be abused. Sometimes it is so well-divided it cannot be used. So it sometimes can be abused because it isn't used. You can run into yourself going the other way.

The executive branch, on the other hand, does have the capacity to focus effort much more directly because there is one person in the end who runs it and can give the signal just like you can in your respective companies.

So what George Bush thinks is very important here, and I would urge you to think about that, maybe talk to some of your fellow CEO's because before the die is cast on the central strategy for the next 4 years I would like to think that there might be an opportunity to have this question of the strategic future of the country and our economic future looked at, especially when you have so many trend lines that are cutting the wrong way and that are a matter of grievous concern, to figure out what we might do to change it and what part you folks might play in the private sector, what part Government might do—maybe the education piece is something we do more of—what part can labor play.

But how do we think in terms of America as a whole? How do we get America on the playing field working as a unit, as a Team

America, in terms of facing off against the rest of the world that lets us succeed not down at this level or sliding back as the chart is showing?

But how do we get ourselves cranked up to a good high level?

How do we get ourselves up to the level of our innate capacity?

As you point out, we have got all of these things going for us.

Why can't we have a success rate that shows us just making tremendous progress in this international framework?

I think we can, but obviously it takes a strategy, and that means the problem has to be focused. It has to be explained.

You have got to develop a sense of urgency, and I couldn't agree more with your point a while ago, and that is that you cannot ask people to pay for something if they don't think there is a problem.

If everything is fine, then they really don't want you knocking on the door to say, by the way, even though everything is fine, I would like you to chip in and do this, whether it is harder work, maybe more in taxes or more in effort, this, that, or the other if everything seems to be fine.

If things are not fine, then I think the American public is quite prepared to say if there is a job that needs doing and you need me to help and everybody else up and down the street is going to help, count me in, I want to help, I will do my part and we expect everybody else to do theirs, and if we all do the part that we can do, then, bang, you know, we can really make a surge.

Somehow we have got to get this across, and I would just finish by saying we carry a special responsibility here, and that is why we are having this hearing.

I would have been here the whole morning if I had not been tied up on the S&L conference, but I feel very strongly that just as we have a special responsibility at this moment in time, which is such an extraordinary one where so much has changed, I think you do as well, and it is a tough assignment because you are running very complicated businesses.

You have corporate raiders looking over your shoulder. You have all kinds of things that make your day as complicated as you could want it to be. But we are going to need a measure of leadership on the public dimension of the larger size of this thing coming from yourselves in addition to just cranking out top notch work effort for your respective companies. Not easy to do, not even sure how to do it, because it is so new in terms of the requirement that is imposed upon us.

You do part of it by coming today and testifying, and we thank you for that because that is a very important use of your time and thought to come and give us your views, and I would hope that beyond today we can figure out a way to really start to marshal the force behind the awareness, the education, the strategy development process that the country just cannot wait any longer to get, and I know that you will play your part in that, gentlemen.

Thank you very much for coming today, and we very much appreciate your testimony. It will be very helpful to us.

Mr. AUGUSTINE. Thank you very much, sir.

Mr. PACE. Thank you.

The CHAIRMAN. The committee stands in recess.

[Whereupon, at 12:30 p.m., the committee was adjourned.]

OVERSIGHT HEARINGS ON THE CONDITION OF U.S. FINANCIAL AND INDUSTRIAL BASE

TUESDAY, NOVEMBER 14, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald Riegle (chairman of the committee) presiding.

Present: Senators Riegle, Garn, Wirth, Pressler, Dixon, Bryan, and Shelby.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. The committee will come to order.

Let me welcome those in attendance. Today, we have what I consider to be perhaps the most important hearing that will be had this year, in terms of the underlying importance to the future of our country. So I am very pleased that we have the witnesses that we do, and I will be introducing them just a little bit later.

I think we have a third witness probably still in transit. I am told that the plane of Mr. Friedman has landed, and he is en route, and so depending upon his luck with getting the right taxi with the right driver, hopefully he will be here before noon. But he should arrive momentarily.

I want to make an opening statement here that really puts on the record our purpose in having such a distinguished set of witnesses today and then again tomorrow. Over these 2 days, we are continuing the hearings that we began in July on the question of whether the American economy is in decline in relative terms, when related to our major international competitors; and if so, what the implications are for the future standard of living for our citizens and ultimately America's position in the world.

The United States, as we know, emerged from World War II as the world's pre-eminent economic power. It was our economic might that permitted America to build the military and political strength needed to stem the tide of totalitarian communism that then threatened to engulf Western Europe and Asia.

The growing strength of the economies of free nations, and recent events in the Soviet Union and Eastern Europe, and very particularly the opening up of the Berlin Wall, suggest that our policy of containment worked, and that we as Americans should be proud of that achievement. But obviously, we cannot rest on those past actions.

Our economic strength is, and will continue to be, the foundation stone of our world leadership. If we have great economic strength, we will be important world leaders. Should we surrender that in any way, then our leadership will diminish, I think, correspondingly.

Over the last several years, I have had a growing concern, shared by many others, about our country's readiness to be an effective competitor in the new and increasingly global world marketplace. It is clear that, if we cannot compete effectively, our relative economic strength will decline, and this will have powerful ramifications not only for our standard of living, but for our national defense and for our future strategic security as well.

Now, in 1985, the Council on Industrial Competitiveness established by President Reagan, and chaired by John Young, the CEO of Hewlett-Packard Co., warned the President with these words—and recall now, this is 1985—that Council on Competitiveness said:

> America's ability to compete in world markets is eroding. Growth in U.S. productivity lags far behind that of our foreign competitors.

That council urged the President to initiate steps to stop the erosion of our industries' competitive ability, noting, ". . . that a strong industrial base is vital to our national security."

Now, in October 1988, last year the Department of Defense Science Board, composed of distinguished industrial and financial leaders, reported in the 8 years since the board's first report in 1980 the following, and I quote them:

> The global political and economic scene has changed considerably. America's technological superiority has diminished. Many countries, including Japan and the Soviet Union, challenge our leadership in technologies essential to defense.

In July, our committee here held the first of this ongoing series of hearings on the competitive condition of America's financial and industrial base in the new global market economy. Testimony from several of the very reputable and thoughtful witnesses suggested that economic trends are now evident that could contribute to a significant reduction of our country's influence in world affairs.

Former Secretary of Defense Carlucci said this:

> You have asked me to identify U.S. industries that are in competitive decline. My response is that we are experiencing a competitive decline across the board.

Admiral Bobby Inman, former Deputy Director of the CIA, agreed, and he said, and I quote him:

> We have got a very different world out there, where our primary political and military allies are our major economic competitors. Until we begin to deal with our ability to compete successfully in that area, we are going to see our standard of living continue to erode.

Mr. Gerald Corrigan, President of the Federal Reserve Board of New York, in commenting on America's growing foreign debt, said this, and I quote him:

> I regard the long-term implications of our very rapid rate of accumulating foreign debt as very dangerous, indeed. It may well have important geopolitical considerations.

John Reed, Chairman of Citicorp, the largest American banking institution, also commented on America's growing debtor nation status, and this is what he said, and I quote him, in a hearing before this committee:

> I would say that, somewhere on this path, we are going to lose our will and ability to be a leader in the world.

Our international debt problem is a result of our loss of competitiveness. Mr. Ikeo Morita of Japan's Sony Corporation, in an October 1 article in the New York Times, stated the following, and I quote him:

> America's loss of competitiveness in so many areas of high-tech manufacturing suggests that there is something fundamentally amiss in American industry.

So the competitive and the comparative economic strength of our country is a matter of the very greatest importance. In fact, every other goal we have in this country—whether it is the drug war, or health programs, or better education, or housing, or whatever it happens to be—depends always in the end on our basic economic strength and capacity.

That is why we have to start there, in terms of any kind of a sensible strategy for America's future. So I will repeat what I have said before, and that is that I intend during my tenure on the Banking Committee as its chairman, to place a focus on many of these fast-developing and disturbing economic trends, so that we can gain a better public understanding of their causes and their implications, and start to think about the kind of serious and comprehensive adjustment strategy that the United States has to hammer out and put into place so that we can start to reverse some of these very dangerous trend lines.

Now, having said that, I will hold off on introducing our witnesses until my colleagues make their opening comments. Let me yield to Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Gentlemen, I apologize for having to leave. It is not unusual around the Senate. But I have two different committee meetings going at the same time. I must run to the other one. I do hope to get back prior to your finishing your testimony and Q-and-A.

But in the meantime, Mr. Chairman, I ask unanimous consent that my statement be placed in the record.

The CHAIRMAN. Without objection, it is so ordered.

[The complete statement of Senator Jake Garn follows:]

STATEMENT OF SENATOR JAKE GARN

Today the Banking Committee will hold a hearing on the condition of the U.S. economy, or at least on the condition of certain aspects of the U.S. economy.

The United States is currently enjoying an unprecedented period of peacetime growth and prosperity. I recall, as a very junior Senator some 11 years ago, that the Congress was considering what many considered a very silly piece of legislation. It was called the Full Employment and Balanced Growth Act, more commonly known as the Humphrey-Hawkins bill. That legislation established goals for the achievement of full employment and zero inflation. That seemed silly and impossible in 1978, when the Humphrey-Hawkins bill was enacted. Today, it is approaching reality.

After a recent upturn, inflation is again declining. Unemployment is down to levels that many argue represent full employment, only structural unemployment remaining. And this unemployment reduction was achieved while ever increasing numbers of Americans have been seeking—and finding—employment.

The goals of the Humphrey-Hawkins legislation, however, are not being achieved through the coordinated governmental economic planning urged in that legislation.

The goals are being achieved by unleashing private initiative through a reduction in marginal tax rates and by other measures that have reduced the burden of government on our citizens.

Now, I am not going to suggest that there are no economic problems facing this country. There are many economic problems. I fear, however, that in merely focusing on problems, we will ignore the great progress and success that we have achieved over the past few years. The budget deficit is on a track of steady reduction. This year it took a sequester to do it. I would rather have seen it done in a different way, but it is being done. As the budget deficit declines, the trade deficit will continue to decline.

The savings rate, which has been a cause of concern, is also improving. Domestic saving has improved to the point where it now exceeds domestic borrowing, at a rate of $50 billion more per year. In fact, savings in August reached an all time high of $191 billion, 110 percent higher than the low of $91 billion reached in August 1987. Would I like to see the savings rate higher still? Yes, I would. But we would be negligent if we did not recognize that improvement is already occurring.

Of course, by looking at trends and drawing trend lines, we can conjure up all sorts of terrifying scenarios. I noticed one the other day that I find absolutely horrifying. It seems that there are currently so many lawyers in the country that there is one lawyer for every 365 persons. What is worse, the number of lawyers is increasing seven times faster than the population is increasing. At that rate, by sometime in the middle of the next century, everyone in America will be a lawyer. I rest my case.

The CHAIRMAN. Senator Wirth.

OPENING REMARKS OF SENATOR WIRTH

Senator WIRTH. Mr. Chairman, I am delighted you are doing this. I could not agree with you more. I think it is, as George Bush would call it, "deep doo-doo." I think it is worse than that. I think we have got some very, very significant problems.

They are economic problems, but they are also problems of perception. You have kind of a revisionist economics coming in that says deficits do not matter. I am going to be looking forward to hearing our witnesses and then asking them about that, you know the Paul Roberts school of economics that seems to think the more in debt you are the better off you are, which is a wonderful change of perception.

I just find it astonishing that this gets worse and worse and worse. These are very important hearings that you are holding. I only wish that there were greater attention to this. This problem is out there, it is a very subtle cancer just eating away at us, and nobody is feeling it so far.

I think we have got to do everything we can to get it back up in the lights to where it belongs. I thank you very much for doing this, and I look forward to hearing our very distinguished panel.

The CHAIRMAN. Thank you very much, Senator Wirth.

Senator Pressler.

OPENING REMARKS OF SENATOR PRESSLER

Senator PRESSLER. I join in those remarks. I am very concerned about the deficit, and also about the growing influence of Japan here. I look forward to hearing Mr. Burstein's comments very much, because although I think we should compete on an even plain, that is not happening in very many instances.

We are becoming a debtor nation, we have become. We are. It is very serious. We are depending on foreign investment more and more. I keep sounding like a prophet of doom, I say this is all going to catch up with us, but it never seems to. Year after year goes by.

But I would say that eventually it has to, unless we change our ways.

The CHAIRMAN. Thank you, Senator Pressler.

Before we start with the witnesses, I have statements from Senators Dixon, Sasser, and Shelby.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee begins 2 days of hearings on developing economic trends. I look forward to the testimony from Prof. Benjamin Friedman of Harvard University, Mr. Daniel Burstein, journalist and author, and Dr. Larry Chimerine of Wharton Econometrics.

The witnesses today present sobering testimony about U.S. savings rates, productivity rates, and increasing foreign ownership of assets. Their conclusions are essentially that the United States will lose its pre-eminent position in the world and its standard of living as a result of these economic trends.

Every American political leader and every American must be troubled by this information. I certainly am.

The Senate Banking Committee has before it two pieces of legislation which I have introduced: S. 305, the Proxmire Financial Modernization Act, and S. 1379, the Defense Production Act Amendments. S. 305 would enhance the international competitiveness of our banks. S. 1379 would be a step forward in preserving and enhancing our technological and industrial base. These two bills are not the only measures—by any means—which we must take to address our international competitive position. They are, however, two areas in which this committee has jurisdiction. I hope the committee will approve legislation this Congress in these as well as other areas, which address the concerns raised by today's witnesses.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, I want to complement you on calling these hearings to take another look at our economic state of affairs. You've assembled three distinguished witnesses who will have much to offer for our analysis.

Our fiscal situation is certainly vexing. The combination of an enormous tax cut and defense spending buildup starting at the beginning of the decade has added $1.9 trillion to the national debt—almost a tripling in our indebtedness.

And there doesn't appear to be an end in sight to borrow and spend policies. The administration has proposed numerous spending initiatives over the past few months—all in worthwhile areas—but there's been little said about how to pay for them.

And for all that's said about our deficits we have a crumbling infrastructure. Indeed, investments in highways, bridges, and education are all things that would increase the productivity of our economy, and increase economic growth. But we're not making them.

It's increasingly apparent, as we watch the Berlin wall come down, that an economic buildup is more important than a military one. And it's no secret that many Americans increasingly see the Japanese as the biggest threat to our economic strength.

But there are other problems besides our budget deficit, and our spending priorities. American companies are losing their competitive edge in world markets. Our corporations are developing a notoriously short-term orientation. Research and development that we desperately need, appears to take back stage to the pursuit of, and defense against, hostile takeovers and LBOS.

So Mr. Chairman, I could go on here, but instead I'll yield so that we can hear sooner from our witnesses. Thank you.

STATEMENT BY SENATOR RICHARD SHELBY

Senator **Shelby**. Mr. Chairman, I appreciate your scheduling this hearing and inviting so distinguished a panel of witnesses. Today's topic is of crucial importance

I have read the written testimony which, while excellent, paints a ominous picture of decline of U.S. leadership. America's fiscal irresponsibility of the past 8 years has jeopardized the future of this Nation. Our enormous budget deficit has swallowed the savings of America, requiring, according to Dr. Freidman, two-thirds of all net savings by U.S. businesses and individuals.

We are a nation of debtors—the U.S. Government is the largest debtor in the world, American citizens owe $3 trillion and the American business sector owes $4 trillion. Quite simply, we enjoy today the fruits of labors yet to be undertaken—We spend today, in all sectors, what we intend to earn tomorrow.

From the beginning of the post-war period until 1981, the United States maintained its position as creditor to the world, confident in its economic superiority. The European Community and Japan set about the task of rebuilding, while Eastern Bloc nations continued on the ill-conceived path of centrally planned economies. The United States was lender of both capital and expertise.

Mr. Chairman, today we find America in a situation similar to that of the classic fable about the tortoise and the hare. Our foreign competitors have steadily gone about rebuilding their war torn economies, while the United States, complacement in its economic strength, experienced spurts of growth while failing to look ahead. Today we find Japan and the European Community slowly overtaking us.

This did not happen overnight. Competitiveness is difficult to quantify but one can get a clearer picture by comparing recent rates of growth in labor productivity and in capital formation. Between 1973 and 1983, real gross domestic product per employed person grew at an average annual rate 0.3 percent in the United States, compared to 2.8 percent in Japan, 2.3 percent in West Germany, 2.2 percent in France, and 1.4 percent in Great Britain. Similarly, manufacturing productivity grew at an average annual rate of 1.8 percent in the United States, compared to 5.3 percent in Japan, 5.2 percent in France, 3.5 percent in West Germany, and 2.4 percent in Great Britain, over the same 10 year period.

As labor productivity declines, the cost of capital in this country has increased, primarily as a result of the meager savings rate in the United States. The United States has the highest cost of capital of the leading industrialized economies, with an after tax cost of capital almost twice as high as Japan's.

Consequently, the United States is spending much less than rival nations on plants and equipment. Over the past 5 years, real fixed investment as a percentage of GNP has averaged almost 30 percent in Japan and almost 20 percent in Europe, but just under 15 percent in the United States.

This does not augur well for the future. America's lag in both of these key components of competitiveness indicate that this Nation will continue to decline relative to foreign competitors. Worse yet, the rate of decline may accelerate.

In order to turn this situation around, it is absolutely essential that the United States increase its net national savings rate. The most obvious way of accomplishing this is to eliminate the budget deficit. Other important steps include lowering capital gains taxes; in Japan, realized capital gains are taxed at 5 percent while in West Germany, gains on investments held longer than 6 months are tax exempt. I also support equalizing the tax treatment of debt and equity by eliminating the double taxation of dividends and I have introduced legislation to this effect. Unfortunatey, such a measure is unlikely to pass before we get the budget deficit under control.

Mr. Chairman, I hope today's witnesses will provide concrete suggestions over what we in this body should do to improve this Nation's competitiveness. I look forward to the question and answer period.

Thank you.

The CHAIRMAN. I also want to make other comments, before introducing our witnesses here. I have been in the Congress 23 years, and I have attended a lot of hearings, and I have had a lot of witnesses, noted people, and people of not particular renown and so forth. I have had the opportunity previously to hear the three of you speak on the topic that we have asked you to testify on before the country today. So I know what you are about to say.

I think this is very likely the single most important hearing that I will have taken part in, in my 23 years in the Congress, and that covers a lot of ground. In the House, in the Senate, a lot of issues and so forth. So I want to tell you at the outset how much I appreciate the work that you have done to bring each of yourselves to the level of knowledge and insight to be able to come today as expert witnesses on this issue.

The importance of the testimony has nothing to do with the size of the room, or who happens to be here and who does not, at this particular point. This is the beginning, the serious beginning, of laying down the foundation of knowledge and insight from which we will develop a national plan and strategy.

I have absolutely no doubt but what that will come about, with this being one of the very important beginning points of the kind of serious change in thinking and change in strategy that must come.

So I do not want anybody to miss the significance of today's meeting here, and what you are about to say. So with that, our witnesses are eminently qualified to speak about this, more so in my mind than anybody else that is available in the country at the present time.

They are Prof. Benjamin Friedman, of Harvard's economics department; Mr. Daniel Burstein, a noted journalist and author; and Dr. Larry Chimerine, an economic advisor to many of our top corporate leaders.

These are men well known and renowned for the work that they have done, and I think are about to present a picture here that the United States of America needs to see and face up to.

Mr. Friedman, let's start with you. I am going to ask you to put the microphone close to you, so that everybody in the room can hear.

STATEMENT OF BENJAMIN M. FRIEDMAN, WILLIAM JOSEPH MAIER, PROFESSOR OF POLITICAL ECONOMY, HARVARD UNIVERSITY, CAMBRIDGE, MA

Mr. **Friedman**. Thank you for your warm welcome, Mr. Chairman, and thank you also for the invitation to address this distinguished committee on what is obviously a very important set of issues.

In your letter of invitation, you asked me to consider whether our economy is in decline in relation to our major competitors, and if so what this implies for the standard of living of our citizens and for America's position in the world.

You also asked me to consider the principal domestic and international reasons for that decline, and what steps could be taken to reverse it.

If I may, I will simply summarize my testimony briefly, and request that the statement that I have prepared be entered in the record.

The **Chairman**. We will make it a part of the record.

Mr. **Friedman**. Thank you, sir.

International economic competitiveness is a genuine problem for the United States today, and one with implications that will become increasingly damaging, not just economically but for the nation's ability to play a leader's role in global affairs as time passes. While I recognize that America's competitiveness problem has many causes, and therefore that policy action along a variety of avenues would be helpful, I believe that our own macroeconomic policies, most particularly the fiscal policy that the United States has pursued since 1981, stand at the center of our competitiveness problem.

America's fiscal policy in the 1980s has been an increasingly costly failure. The continuing huge imbalance between the Federal Government's revenues and expenditures, which became acute as the U.S. economy began its recovery from the 1981–82 business downturn, has been unprecedented in U.S. peacetime experience. It has already more than doubled the national debt, even on an after-inflation basis, just since 1980. It also shows little sign of genuine improvement, especially after allowing for the increasing use of the Social Security System's surplus to mask the deficit in the general account. The Congressional Budget Office's most recent forecast projects a continual widening of the on-budget deficit over the next half-decade, under a continuation of current tax and spending policies.

There is a widespread misperception that this deficit has resulted in large part from over-spending by the Congress compared to the budget request of the President. I think it is worth addressing that misperception quite directly. If we add up all of the spending that Congress has voted during the fiscal years 1982 through 1988—I use 1982 through 1988 because although President Reagan was in office in 1981, but the budget was actually Jimmy Carter's—we find that Congress spent $117 billion more than President Reagan requested. By contrast, the total deficit accumulated during this period was more than $1.3 trillion. In other words, over-spending by Congress, compared to President Reagan's requests constituted less than 10 percent of the total deficit during this period.

The economic consequences of our unhinged fiscal policy have affected prospects both for the nation's domestic economic well-being and for its economic role internationally. In both dimensions, the fiscal policy that the United States has pursued since 1980 has sacrificed the economic prospects of Americans in the future, in order to spur the consumption that Americans are able to enjoy today.

Since 1981, the Government's borrowing has absorbed nearly two-thirds of all the net saving done by American businesses and individuals. On average during the 1980s, the total amount of savings that American businesses and American families have done, over and above what has been necessary merely to allow for depreciating assets as they wear out, has equalled 5.6 percent of our gross national product. Compared to that 5.6 percent net private saving rate, the Federal budget's absorption has been 4.1 percent of our GNP, on average, through the decade.

As a result, real interest rates—that is, interest rates measured in comparison to price inflation—have been at record levels on average throughout the decade. On average during the 1950's, the 1960's and the 1970's, the commercial paper rate—the rate for unsecured, short-term business borrowing—was less than 1 percent above the inflation rate. On average since 1980, the commercial paper rate has exceeded the inflation rate by 5 percent.

With such a high real cost of funds, net business investment in new plant and equipment has averaged barely 2 cents out of every dollar of total U.S. income. That is less than in the 1950's or the 1960's or the 1970's, despite the business investment incentives that we legislated in 1981. In short, the policy that was supposed to stimulate saving and investment in America has instead led to the poorest investment performance, and the lowest saving rate, in 40 years.

As a result, it is not surprising that our economy's rate of productivity growth, outside of a few particular areas, has continued to be disappointing and it is also not surprising that business has therefore been unable to pay higher real wages. We continually hear that the United States is now in the midst of what has become the longest-running business expansion in U.S. peacetime history. That is correct. What few people bother to point out, however, is that this is the first business expansion in more than 50 years in which the average wage earned in American business has not kept pace with inflation. In 1983, the first year of this expansion, the average worker in American business earned $281 a week. If we restate today's wages in 1983 dollars, the average worker no longer earns $281 a week, but $272 a week: All this in the midst of what is supposed to be record prosperity.

The consequences of America's misbegotten fiscal policy have been even more serious in the international context, on which this hearing focuses. By raising real interest rates in the United States above real interest rates abroad, for the first time since 1976, the Federal Government's massive borrowing also drove U.S. dollar exchange rates to unsustainably high levels in relation to major foreign currencies. As a result, the international competitiveness of American business collapsed. One industry after another lost the ability to make sales abroad, or even to defend its markets at home. Between early 1985 and late 1987, the dollar fell sharply, and in due course this country's trade gap began to turn around. But since then the dollar has leveled off and even risen, and it remains over-valued compared to other countries' currencies. The improvement in the trade balance has stalled as well.

On a rough average basis, the U.S. dollar declined continually from 1950 to 1980, a period during which our international accounts were approximately in balance, at the rate of about 2½ to 3 percent per annum. If we had merely kept along this trend line—which, again, marked a period during which our international accounts balanced—the dollar today would therefore be, on average, 25 to 30 percent below the 1980 level. By contrast, with real interest rates so high as they have been in the United States during the 1980s, even despite the fall of the dollar during 1985 through 1987, the dollar today is not below the 1980 level at all; it is above the 1980 level.

Moreover, having now neglected our investment in new capacity for nearly a decade, especially in manufacturing and other industries that produce for export or to compete against foreign goods in U.S. markets, we can no longer say that the over-valued dollar is the sole source of our problem. Indeed, we are increasingly discovering that a cheap dollar policy alone will not be enough to restore U.S. competitiveness.

In the meanwhile, U.S. dependence on foreign lenders to finance the country's trade imbalance continues to grow. Having to pay for this steady flow of imports in excess of exports has not only dissipated what was once the world's largest net international investment position, but now transformed the United States into the world's largest debtor country. The swing since 1981 has already amounted to some $11,000 for every American family of four. It is little wonder that most Americans think they are living well. After borrowing $11,000 a family from foreigners, they certainly should be.

At the end of 1988, our net debt owed abroad—that is, what we owed to foreigners, over and above what they owed to us—was $533 billion. That amounted to slightly more than 10 percent of our gross national product last year. At the end of this year, 1989, our net debt owed abroad will be in the range of $675 to $700 billion. That will amount to 13 percent of this year's gross national product. On our current trajectory, our net debt ratio—our net debt owed abroad compared to the size of our economy—will reach 17 percent or even 18 percent by 1992, and 20 percent or perhaps even 21 percent by 1996.

This means that, even compared to our large economy, the United States is very much a world-class debtor. With Brazil's net debt ratio in the mid-20's and Mexico's in the range of 35 percent, if we reach a net debt ratio of 20 percent to 21 percent by 1996 we will have serious problems.

In particular, Americans in the future will have to service these debts. We will do so in part by paying interest to foreigners outright, but probably even more so by selling off to foreign buyers the ownership of our country's businesses and real estate. Foreign conversion of U.S. bank deposits and U.S. Treasury obligations into equity securities, office buildings, and outright ownership of whole companies, has recently attracted widespread attention. In fact, the process has merely begun. In the future, on this trajectory, America's assets will still be there, and they will still be profitable; but Americans will no longer own them.

At the same time, the power and influence that traditionally accrue to creditor countries will no longer be America's to claim. It is a fact of life that people simply do not view their debtors in the same light as they do their creditors. It is no accident that America emerged as a world power simultaneously with our transition from being a debtor nation, dependent on foreign capital for our initial industrialization, to a creditor supplying investment capital to the rest of the world. The same happened in Spain in the 16th century, and in Britain in the 19th century.

But we are now a debtor again, and our future role in world affairs is in question. If we continue on our current trajectory—and by that, again, I mean a net debt ratio rising to the range of 20 percent by the mid-1990's—then over time, our role in world affairs will gradually shift to Japan and Germany, or still other new creditor countries that are able to supply resources where we cannot. America's influence over nations and events will ebb. Watching our economic power shift to these new countries as they begin to cope with the developing world's debt, for example, or step in to prevent a dollar crisis, or step in to assist the transition that is now underway in Eastern Europe—in each case presumably in ways that promote their own commercial and diplomatic advantage rather than ours—is merely the price that we shall have to pay for the fiscal policy we have pursued throughout the 1980's.

Most Americans continue to think of themselves as creditors, and we readily offer unsolicited advice to other debtor countries as if somehow they had fallen into a trap that we had successfully avoided. At the same time, the Japanese and Germans often still appear to think of themselves as debtors. But attitudes toward world leadership will change soon enough, as our financial problems circumscribe our scope for maneuver in world affairs, while the new creditors' financial strength does the opposite. Just how large a departure from recent history the resulting new international arrangements will represent depends in part on whether and how we change our economic policy. I take that to be what these hearings are all about.

In the meanwhile, especially in light of the astonishing events now taking place throughout Eastern Europe, for us to continue to rely on U.S. military prowess alone to guarantee our nation's international clout, when the economic basis underlying our prosperity has been dissipated, will be a sorry and a risky role for Americans to play in world affairs.

Thank you, Mr. Chairman, for giving me the opportunity to present my views to this distinguished committee.

The **Chairman**. Mr. Friedman, let me just say before we go to the next speaker that I consider that to be a truly brilliant analysis. You know, when things come out in an orderly fashion, it is somehow easy to somehow assume that it does not take thousands of hours of work and analysis to put that thinking together. It clearly has in your case.

I just want to say, not only as a Senator but as a citizen, how much I appreciate the thoughtfulness and the care that goes into that effort to try to make sense out of this current dilemma.

Mr. **Friedman**. Thank you, sir.

[The complete statement of Benjamin M. Friedman follows:]

November 14, 1989

TESTIMONY BEFORE THE UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Benjamin M. Friedman
William Joseph Maier Professor of Political Economy
Harvard University

Mr. Chairman:

I am grateful for the opportunity to present my views to this distinguished committee as it considers the likely consequences of America's increasingly evident inability to compete in world markets, and evaluates potential policy actions to contain or even reverse this highly troubling situation.

International economic competitiveness is a genuine problem for the United States, and one with implications that will become increasingly damaging -- not just economically, but for the nation's ability to play a leader's role in global affairs -- as time passes. I therefore applaud this committee's initiative in holding this series of hearings to renew the sense of urgency with which the American public views this complex set of issues, and to explore just what steps the Congress and the President ought to take in response.

While I recognize that America's competitiveness problem has many causes, and therefore that policy action along a variety of avenues would be helpful, in my testimony today I shall emphasize primarily the role of U.S. macroeconomic policies -- monetary policy, and especially fiscal policy -- in bringing about our current plight. In doing so I do not mean to denigrate the

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This testimony draws in part on my recent research and writings, including especially Day of Reckoning: The Consequences of American Economic Policy Under Reagan and After (Random House, 1988).

role of other contributing factors, nor the opportunities for making progress in other policy areas. For example, restrictive trade practices in some of America's leading trading partners have apparently been important in this regard, and trade policy remains a key tool for promoting U.S. competitiveness. But I believe that our own macroeconomic policies -- again, most particularly the fiscal policy that the United States has pursued since 1981 -- stands at the center of our competitiveness problem. Moreover, unlike government policies and private business practices in other countries, which at most we can influence at a distance, our own fiscal policy lies entirely within the power of the Congress and the President.

America's fiscal policy in the 1980s has been an increasingly costly failure. The continuing huge imbalance between the federal government's revenues and expenditures, which became acute as the U.S. economy began its recovery from the 1981-82 business downturn, has been unprecedented in U.S. peacetime experience. It has already more than doubled the national debt, even on an after-inflation basis, just since 1980. It also shows little sign of genuine improvement, especially after allowing for the increasing use of the Social Security System's surplus to mask the deficit in the general account. The Congressional Budget Office's most recent forecast (August, 1989) projects a continual widening of the "on-budget" deficit over the next half-decade, under a continuation of current tax and spending policies.

The economic consequences of this unhinged fiscal policy have affected prospects both for the nation's domestic economic well-being and for its economic role internationally. In both dimensions, the fiscal policy that the United States has pursued since 1980 has sacrificed the economic prospects of Americans in the future in order to spur the consumption that Americans are able to enjoy currently. Like a family on a binge, America is living beyond the country's income, financing continuous overspending with a combination of taking on debt and selling off assets. The main difference is that, in contrast to a family that for one reason or another chooses such a path on its own accord, the nation's splurge has resulted from a set of policies that Americans endorsed at the polls because they were advertised to strengthen the country's productivity and competitiveness, not erode them.

Costs of America's 1980s Fiscal Policy: An Overview

In retrospect, the idea that reducing tax rates would increase tax revenues, and thereby finance a major defense build-up without cuts in major spending programs like Social Security and Medicare, was a joke. Over the seven fiscal years spanning 1982-88 (the 1981 budget was still Jimmy Carter's, and at the time of writing I do not have the final results for 1989), savings on defense spending came sufficiently close to offsetting the excess for non-defense programs that the total amount Congress spent for all purposes other than paying interest on the national debt added up to $117 billion more than what President Reagan requested. The federal budget deficit for those seven years added up to nearly $1.3 trillion.

The economic consequences of this ironic turn of events (in presenting his first budget to Congress, in February 1981, President Reagan asserted that "the ship of state" was "out of control" because the government's total outstanding debt was then nearing $1 trillion) are by now well known. Since 1981 the government's borrowing has absorbed nearly two-thirds of all the net saving done by American businesses and individuals. As a result, real interest rates -- that is, interest rates measured in comparison to price inflation -- have been at record levels on average throughout the decade. With such a high real cost of funds, net business investment in new plant and equipment has averaged just 2.1% of U.S. total income, less than in the 1950s or the 1960s or the 1970s, despite the business investment incentives legislated in 1981. The policy that was supposed to stimulate saving and investment in America has instead led to the poorest investment performance, and the lowest saving rate, in forty years.

At the same time, the government's own borrowing has hardly served to finance any surge of investment in roads or bridges or other "infrastructure" that might serve as a substitute for private capital formation. The share of federal spending that has gone into non-defense capital investment has steadily shrunk, from 2.1% on average in the 1950s and 1960s, to 1.5% in the 1970s, and now just 1.2% in the 1980s. There is no reliable way to predict what gains in productivity American business will achieve in the next few years. But to the extent that those gains will depend on investment in physical capital, either private or public, they are sure to be disappointing.

As the focus of today's hearing rightly suggests, however, the consequences of America's misbegotten fiscal policy of the 1980s have been even more serious in the international context. By raising real interest rates in the United States above real interest rates abroad, for the first time since 1976, the federal government's massive borrowing also drove U.S. dollar exchange rates to unsustainably high levels in relation to major foreign currencies. As a result, the international competitiveness of American business collapsed. One industry after another lost the ability to make sales abroad, or even to defend its markets at home. Between early 1985 and late 1987 the dollar fell sharply, and in due course this country's trade gap began to turn around. But since then the dollar has leveled off, and even risen, and it remains overvalued compared to other countries' currencies. The improvement in the trade balance has stalled as well. Moreover, having now neglected our investment in new capacity for nearly a decade, especially in manufacturing and other industries that produce for export or to compete against foreign goods in U.S. markets, we are increasingly discovering that a cheap dollar policy alone will not be enough.

In the meanwhile, U.S. dependence on foreign lenders to finance the country's trade imbalance continues to grow. Having to pay for this steady flow of imports in excess of exports has not only dissipated what was once the world's largest net international investment position, but transformed the United States into the world's largest debtor country. The swing since 1981 has already amounted to some $11,000 for every family of four. It is little wonder that most Americans think they are living well. After borrowing that much from foreign lenders, they certainly should be.

America's foreign debt is real, not a statistical illusion. It makes no sense to argue that this massive inflow of funds merely reflects this country's stable political environment, or its favorable business climate. Ecuador and Zaire also have large capital inflows and, as a result, growing debts owed abroad. It would be absurd to pretend that those countries' growing debts were due to anything other than an inability to export enough to balance their imports. The same is true in the U.S. case.

Americans in the future will have to service these debts. We will do so in part by paying interest to foreign lenders outright, but probably even more so by selling off to foreign buyers the ownership of the country's businesses and real estate. Foreign conversion of U.S. bank deposits and U.S. Treasury obligations into equity securities, office buildings and outright ownership of whole companies has only just begun. America's assets will still be there, and they will still be profitable. But Americans will no longer own them.

At the same time, the power and influence that traditionally accrue to creditor countries will no longer be America's to claim. People simply do not view their debtors in the same light as they do their creditors. It is no accident that America emerged as a world power simultaneously with our transition from a debtor nation, dependent on foreign capital for our initial industrialization, to a creditor supplying investment capital to the rest of the world. The same happened in Spain in the sixteenth century, and in Britain in the nineteenth.

But we are now a debtor again, and our future role in world affairs is in question. If we continue on our current trajectory, over time that role will gradually shift to Japan and Germany, or still other new creditor countries that are able to supply resources where we cannot, and America's influence over nations and events will ebb. Watching our economic power shift to these new creditors -- as they begin to cope with the developing world's debt, for example, or step in to prevent a "dollar crisis," in both cases presumably in ways that promote their own commercial or diplomatic advantage -- is merely the price we shall pay for the fiscal policy we have pursued throughout the 1980s.

Most Americans continue to think of themselves as creditors, and we readily offer unsolicited advice to other debtor countries, as if they had fallen into a trap that we had successfully avoided. At the same time, the Japanese and Germans often still appear to think of themselves as debtors. But attitudes toward world leadership will change soon enough, as our financial problems circumscribe our scope for maneuver in world affairs while the new creditors' financial strength does the opposite. Just how large a departure from recent history the resulting new international arrangements will represent depends in part on whether, and how, we change our economic policy. In the meanwhile, especially in light of the astonishing events now taking place throughout eastern Europe, continuing to rely on U.S. military prowess to guarantee the nation's international clout, when the economic basis underlying it has been dissipated, is a sorry -- and a risky -- role for Americans to play.

The Route from Creditor Country to Debtor

However much the vast array of other influences at work may have aggravated the situation, it is difficult to escape the conclusion that America's loss of international competitiveness in the 1980s has sprung in large part from the overvalued dollar. At a more fundamental level, it is therefore a product of the nation's new fiscal policy. Because of the dollar's remarkable rise in the first half of the decade, more of the cost of that fiscal policy has fallen on the economy's international sector, and correspondingly less on domestic capital formation, than most cleared-eyed assessments of the new policy's likely effects originally predicted.

But even if the dollar were now to fall to a level low enough that the entire cost of America's new fiscal policy shifted back onto the economy's domestic capital formation, and the nation's imports and exports somehow regained the equilibrium they had displayed for so many years until the 1980s, Americans' new international burden would not disappear. Even if the nation now abandoned the fiscal aberration of the 1980s altogether, and returned to the approximate balance of government spending and government revenues that had characterized its entire prior peacetime experience, the country's international economic prospects would still not be as they were a decade ago. The fiscal excesses of the 1980s have left a sizeable burden for Americans to pay to foreigners in future years.

The bulging excess of imports over exports that the United States has run throughout the 1980s has meant that Americans have been spending more, on all goods and services combined, than the nation has been producing. Between 1980 and 1988, total spending in the United States -- including consumer spending, all business and residential investment, and all spending by government other than mere transfers and interest payments -- rose by 31% after allowing for inflation. But total U.S. production rose by only 26% during these years. The widening gap between what Americans spend and what we produce has required importing an ever greater volume of goods produced abroad, in excess of the U.S.-made goods exported for use elsewhere.

But Americans have also had to pay for this excess. We have done so by borrowing from abroad. And as we have borrowed from foreigners in even larger amounts, to finance the growing gap between the goods we have bought and the goods we have sold, the debt we owe to foreigners has accumulated. It has already far eclipsed the debt that foreigners owe to Americans, and it is continuing to accumulate further as long as the country's international trade remains out of balance.

Like any newly developing country, especially one that is a colony of a larger and older country, the United States began its economic life as a net borrower from abroad. Foreign borrowing was especially important to U.S. economic development during four key periods, all during the nineteenth century. But after the early 1890s, much of the nation's rail and telegraph network was in place, and so were the makings of its new industrial base. Just as importantly, incomes were higher, and therefore so was the country's own available saving. The United States had grown past its period of need for foreign capital. Net inflows of foreign saving, in excess of outflows of Americans' saving, slowed sharply in the early 1890s. From 1897 on, Americans were investing more of their own saving abroad than the amounts of foreign saving that they took in. Apart from World War II and a few other scattered years, we continued to do so until 1982.

As Americans after 1896 continued to be net suppliers of their saving to foreign countries, rather than net users of other countries' saving, the accumulated U.S. net foreign debt shrank. Two decades proved sufficient to eliminate it all together. The last year in which Americans owed more abroad than foreigners owed them was in 1914. U.S. foreign lending surged to new record volumes as World War I began in Europe, in August of that year. Early in 1915, the United States became a net creditor.

For the next six and a half decades, Americans continued to be net lenders to the rest of the world in almost every year. As they did so, their overall net foreign asset position steadily grew. By 1940 Americans held $34 billion of assets abroad versus only $14 billion of foreign-owned assets here. By 1970 the gap in this country's favor had widened to $166 billion versus $107 billion. And even during the seventies, a period that most Americans do not recall with fondness for its economic successes, the gap continued to widen. By yearend 1981, Americans held $720 billion of assets abroad, versus foreign-owned assets here of just $579 billion. But 1981 was the last time Americans were net suppliers of saving to other countries. That year's $141 billion net asset position marked the high point of the U.S. status as a net creditor country.

The reversal of America's international financial position in the 1980s has been just as spectacular as the decline in the country's competitiveness that lay behind it. Just three years under the nation's new fiscal policy, through 1984, was sufficient to dissipate the entire net foreign asset position that three generations of Americans had accumulated since 1914. Just the next four years under the same fiscal policy, through 1988, have already built up the world's largest net foreign debt position for the next generation of Americans to service. Because the dollar is no longer falling -- and because the improvement in the country's trade flows has lagged behind the fall in the dollar anyway (as it always does) -- the next four years, through 1992, appear certain to balloon the U.S. net foreign debt position to a whole new order of magnitude.

The root of America's sudden decline from the world's largest net creditor to its largest net debtor has been the extraordinary mushrooming of the federal government's budget deficit to levels that absorb the majority of the net saving done by individual Americans and American businesses. With most of Americans' own saving going to finance the government's shortfall, it was inevitable that either domestic capital formation would shrink or the country would begin to draw in foreign saving by a widening import-export gap. The Federal Reserve System has conducted monetary policy in such a way that the ensuing pattern of real interest rates and dollar exchange rates has resulted in some of both. Just as the country's reduced investment rate has left a permanent legacy in the form of a lower stock of productive business and residential capital than it otherwise would have had, the massive reliance on foreign saving has transformed the United States from a net international creditor to a net debtor -- with all the loss of power and influence that that change in status implies.

The U.S. net foreign asset position first began to slip in 1982, the same year that the federal government's deficit first rose above $100 billion. The deterioration in 1982 was only $5 billion, however, and that year's federal deficit was due more to economic weakness than to expansionary fiscal policy anyway. The more serious erosion followed in 1983 and 1984, as the government's deficit widened further despite the advancing business recovery. Between yearend 1981 and yearend 1984, Americans' foreign holdings grew from $720 billion to $896 billion. But foreign assets in the United States grew from $579 billion to $893 billion. The country's entire net foreign asset position was almost gone. Moreover, $446 billion of U.S. foreign assets in 1984, almost half of the total, consisted of loans made by U.S. banks to foreign borrowers. And $238 billion of those loans were to developing countries, whose ability ever to repay what they owed was dubious at best.

The United States officially became a net debtor country again in the first weeks of 1985. By the end of the year, foreign assets in the United States exceeded Americans' foreign assets by $111 billion -- almost as much as the difference going the other way had been, just three years earlier. America's net foreign borrowing in just one year had exceeded the entire outstanding indebtedness of Mexico or Brazil. Since then the pace has quickened. By yearend 1988 America's net foreign debt was $533 billion, twice as much as that of Mexico, Brazil and Argentina combined. By the end of this year it will presumably be in the range of $700 billion, even still counting all of American banks' foreign loans at a hundred cents on the dollar. Estimates of a net debt position surpassing $1 trillion by early in the 1990s, which once seem absurd, now appear to be a virtual certainty. (Although public discussion of this issue has at times focused on well known shortcomings in the official international accounts, on balance there is no reason to believe that a more accurate set of accounts would be more favorable from the U.S. perspective. The main adjustments in America's favor -- marking to market both our gold holdings and our foreign direct investment -- would probably about offset the effect of allowing for unrecorded capital inflows and marking to market U.S. banks' loans to less developed countries. More importantly, what matters in this discussion is not the current position, but the trajectory on which the United States is now traveling, and about that there is little dispute.)

Net foreign debt on even the current scale has already placed the United States at the top of the roster of world-class debtors. Worse still, the United States is rapidly becoming more heavily indebted than any other major country, even in relation to its large size. The roughly $700 billion that the nation will owe on a net basis at the end of this year will represent more than 13% of the country's total income for this year -- a large net debt ratio, to be sure, but still well below comparable net foreign debt ratios in the range of 20% for Argentina, of 30% for Brazil, or 40% for Mexico. But if the U.S. net foreign debt continues to grow at the current rate of $150 billion per year, while national income grows at 7% per annum, the U.S. net debt position will represent nearly 18% of U.S. annual income by 1992, and nearly 21% by 1996.

Economic Implications of Being a Net Debtor

In 1980 Americans could easily afford the $26 billion excess of merchandise imports over merchandise exports that we ran, because we also earned $36 billion more on our foreign holdings than foreign investors earned on their U.S. holdings. That advantage, however, depended largely on owning more assets abroad than foreigners owned here. The nation's new fiscal policy has already dissipated the differential in ownership, changing what used to be a net foreign asset position into a net foreign debt position. As a result, the U.S. surplus of income earned from foreign assets is shrinking, and in time it too will disappear.

A major economic legacy of the fiscal policy of the 1980s is the nation's growing foreign debt. Because of the need to service that debt, Americans in the future will have to live on less than what we produce and earn. The fact that the incomes out of which we will have to pay this debt service to foreigners will already be diminished, as a result of inadequate capital formation and sluggish productivity growth, will only make the resulting deterioration in the country's ability to raise its citizens' standard of living all the greater.

As is the case for so many of the world's other major debtors, ranging from large ones like Brazil and Mexico to small ones like Ecuador and Zaire, for the foreseeable future there is no prospect of America's paying off this debt. The issue is instead how to pay the interest. Even at fairly modest interest rates, merely paying the interest on the debt that the United States now owes, as of the end of the 1980s, will take between one and two percent of the country's total income each year. If the debt owed to foreigners is not to keep rising even further -- in other words, if the United States is actually going to pay the interest it owes, rather than borrowing that too -- U.S. imports will have to shrink to less than U.S. exports by approximately that margin.

The United States as a debtor nation will therefore have to maintain a continual trade surplus. But the proceeds of that surplus will not accumulate into wealth held abroad by Americans, nor even go toward reducing the U.S. net international indebtedness. Net proceeds from international trade in the amount of one to two percent of the country's total income will merely be enough to pay the interest on the debt already owed as of the end of the 1980s. Actually paying down this debt, as the United States did between the mid 1890s and the beginning of World War I, would require an even larger trade surplus.

In 1988 U.S. merchandise imports exceeded exports by $127 billion, or 2.6% of the country's total income. Moving from this deficit to a trade surplus, of the size required merely to service the net international debt that will be outstanding at the end of the decade, will therefore constitute an adjustment equal to approximately four percent of the total income that Americans produce and earn each year. Some part of this four percent swing will consist of goods and services from abroad that we will do without in order to service our foreign debt. The rest will consist of additional goods and services that we will work to produce not for our own use but for export.

When and how the United States will make this major adjustment will not be entirely, or even largely, up to this country's discretion. As is the case for any kind of borrower, after some point a debtor country's ability to keep increasing what it owes depends mostly on choices made by others. In this case, the speed and extent of the adjustment involved in ending America's current consumption binge, and even beginning to pay for it, will mostly depend on how much appetite foreign investors have for owning assets in this country.

As long as foreign investors as a group continue to want to increase their holdings in the United States more rapidly than Americans are increasing their holdings of assets abroad, this country can continue to borrow what it needs to pay interest on its outstanding international debt, and perhaps also to finance an ongoing excess of imports over exports. But its ability to do so will hinge crucially on foreigners' continuing demand to own ever more U.S. assets -- importantly including not just debt instruments, whether they are issued by the U.S. Treasury or U.S. banks or even yet other private American borrowers, but also equity securities and the entire available range of direct investments.

Once foreign investors have accumulated enough U.S. holdings that they are willing to increase their net position in the United States only to the extent of accumulating the interest, dividends and other returns that they earn on their U.S. investments, this country will be able to borrow only the debt service it owes. At that point -- which clearly has not yet arrived -- the dollar will fall by enough to bring U.S. imports and exports into balance. Any continuing excess of imports over exports then will just send more dollars abroad than the amount that foreigners want to put into additional holdings of U.S. assets. As foreign investors collectively try to sell their extra dollars in the foreign exchange market, they will only drive the dollar's exchange rate still lower. The dollar's fall will stop only when the country's imports finally match its exports.

And whenever foreign investors have accumulated enough holdings in the United States that they are unwilling to increase their net position at all -- in other words, when they are willing to increase their ownership of assets in America no more rapidly than Americans are increasing our ownership of assets abroad -- the United States will not even be able to borrow the debt service it owes. It is at this point that America's trade balance will have to move into surplus in order to enable the country to earn, not borrow, whatever it needs to pay the interest and dividends it must pay each year to foreigners. The dollar will then have to fall to whatever level is necessary to enable U.S. exports to exceed American imports, by at least enough to earn each year's debt service. Otherwise, even the payment of interest and dividends would only send more dollars abroad than foreign investors need in order to buy American goods, or want in order to buy U.S. assets. And once again, the effect of their collectively trying to sell their extra dollars in the foreign exchange market would just push the dollar exchange rate still lower.

A continuing inability of U.S. industry to compete even at a lower exchange rate, or a continuing large appetite of Americans for foreign-made goods even at higher prices, means only that the dollar will have to fall so much further. Even if U.S. industry could not compete at any exchange rate, a cheap enough dollar would finally make many imports too expensive for most Americans to afford. Having to make do without the imported products that made up the $127 billion U.S. trade deficit in 1988 would mean a sharp reduction in Americans' standard of living. Having to suppress imports by still more, to generate a trade surplus large enough to service the outstanding U.S. debt, would depress living standards even further. Finding opportunities to increase U.S. exports would make this adjustment less painful, because in that case we would need to cut back less on our imports. But America's adjustment to a trade surplus will take place anyway, with or without growing U.S. exports, on whatever schedule foreign investors' asset preferences dictate.

Despite the magnitude of this adjustment, it would be in America's own best interest to have it over with as quickly as possible. The need for a swing in the nation's trade balance amounting to approximately four percent of each year's total income already represents a huge drop in living standards -- about twice what occurs in a typical business slowdown. But even that is merely the price of the damage already done. The longer the country's binge based on foreign borrowing goes on, the further living standards will ultimately have to fall in order to pay for it.

Touchy Questions About Who Owns What

The increasingly popular view that America's export-import balance must swing into surplus soon, because foreign lenders will exhaust their willingness to hold ever greater amounts of U.S. IOUs, would be persuasive if there were nothing other than U.S.-made goods that foreigners could take in exchange. In that case the dollar would stop falling only when this country developed a large enough trade surplus to earn the interest due on its outstanding foreign debt. Otherwise, servicing the debt by paying out dollars, while paying out still more dollars to finance a continuing export-import deficit, would mean sending more dollars abroad than what foreign investors were willing to hold. Their collective efforts to sell these extra dollars, with no one to sell to but one another, would continue to drive the dollar exchange rate still lower. The dollar's decline would stop only when this country's exports exceeded its imports by enough to earn the interest due on the country's net foreign debt.

But foreign investors can and do use dollars to buy American assets other than plain IOUs. Stocks listed on the New York Stock Exchange, direct ownership interests in American companies, office buildings in New York City, condominiums in Miami, and farm land in Kansas and California, all take dollars to buy. Foreign investors will still need dollars if they want to buy any of these other U.S. assets. There is every reason to believe that they will want to do so. Even in the climate of price stability that has prevailed since the 1981-82 business slowdown broke the momentum of American inflation, foreign investors' interest in American assets other than deposits and debt securities has already been growing strongly.

Some of this interest has simply taken the form of ordinary stock-buying for portfolio purposes. With Japanese companies' stocks now selling at roughly fifty times earnings on average, versus thirteen times earnings for American companies, the relative attractiveness of the American market is compelling. Increasingly, however, foreign investors have bought shares in American companies and also American real estate, in such a way as to acquire not just ownership but control. With the price of prime commercial real estate approximately ten times higher in Tokyo than in New York on the basis of current exchange rates (in part as a result of Japanese Government farm subsidies, which increase land prices there generally), office buildings in New York are bargains by comparison. Moreover, foreign purchases of American real estate have involved more than just these highly visible purchases by major financial institutions. As economic distress has driven large amounts of "flight capital" out of Latin America, much of it has found its way into houses, condominiums and farms throughout this country.

Despite the rapid acceleration of the past few years, foreign purchases of U.S. real assets have not been able to keep pace with the flood of dollars that the United States has sent overseas to pay for the country's exploding trade imbalance. Buying a company is usually a slow process. So is buying a major block of real property. Careful investors want to search for potential acquisition targets, evaluate alternatives, and assess their ability to manage a business once they own it. As a result, foreigners have simply accumulated most of their growing pool of dollars in bank deposits, U.S. Treasury bonds, or other debt securities. As of yearend 1980, 45% of private foreigners' U.S. holdings were in stocks and direct investments. Yet despite the widely publicized acceleration of stock purchases and direct investment purchases in the last few years, and despite the large increase in stock prices since 1980 (notwithstanding the 1987 market crash), by yearend 1988 only 36% of foreigners' U.S. holdings were in stocks and direct investments.

There is every reason to expect that foreign investors will invest progressively more of their dollars in America's real assets as time passes. Even apart from any fear of this country's returning to high inflation, merely restoring foreigners' U.S. holdings from their current debt-heavy composition to prior historical norms will involve continuing purchases of stocks, and continuing direct investment, on a vast scale. The prospect of another round of high inflation, which would erode the value of deposits and debt instruments denominated in dollars, would only make such real assets all the more attractive.

A major implication of foreign investors' huge appetite for owning America's real assets is that this country's binge of consumption based on foreign goods not paid for with U.S.-made goods may go on longer than most people now expect. The fact that foreigners may be unwilling to continue to accumulate ever larger net holdings of U.S. debt securities does not mean that they will not want dollars for investment purposes. As long as they continue to use the dollars that the U.S. trade deficit sends abroad by exchanging them for U.S. assets, the further downward pressure on the dollar exchange rate that their efforts to sell dollars would otherwise produce will not occur. Just which U.S. assets they take in exchange is unimportant in this context. What matters is that foreigners will be using their dollars to buy something that the United States can provide -- in this case, America's industry and real property -- and not trying to sell them in the foreign exchange market. As a result, America's transition from running up ever larger amounts of foreign debt to paying the interest on what the country already owes will take all the longer.

Keeping the binge going by selling off the country's real assets will make the trade adjustment slower, and therefore easier to swallow both for this country and for our international trading partners. But it will also make the mortgage on Americans' future, and the reduction in our standard of living that meeting our obligations will require, all the greater. If the adjustment were to be completed by 1992, the U.S. net foreign debt position would probably level off at roughly $1 trillion. If the U.S. export-import deficit narrows more slowly, however, and averages $100 billion per year in the early 1990s, by 1996 the country's net foreign debt will be larger by not only $500 billion or so of accumulated trade deficits but also the debt service payments borrowed along the way.

In Conclusion: A Historical Contrast

What will make servicing this foreign debt all the harder is that in the 1980s America has borrowed not to invest, but to consume. After all, issuing debt in order to finance new facilities is standard practice for most soundly run businesses. And most developing countries rely heavily on net inflows of foreign capital to finance their early industrialization -- as the United States did during four significant periods in the nineteenth century. If a business is successful, it will earn enough revenue from its new facilities to service its debt, and add to its profits too. If a country's economic development is successful, as America's was, it will generate enough income to service the country's foreign debt and also raise its citizens' standard of living.

But the United States in the 1980s has been running up foreign debt without putting up domestic investment. Whether or not the returns from the country's additional capital formation will prove sufficient to finance the country's foreign debt service is not an issue, because there has been no additional capital formation in the first place. Because of America's radical new fiscal policy, the share of U.S. income going into net business investment in the 1980s has not been greater than ever before, but smaller.

Americans in the 1980s are borrowing from foreign lenders on a scale that exceeds what our great-grandparents did during the peak period of U.S. foreign borrowing in the late 1860s and early 1870s. Even at the height of the country's reliance on foreign capital, to finance its railroads and the beginnings of its steel industry, the annual net inflow of saving from abroad averaged just 2.2% of annual U.S income. Since 1984, when the nation's new fiscal policy first hit full stride, each year's net inflow of saving from abroad has averaged 2.8% of yearly U.S. income.

But unlike a century ago, the United States in the 1980s is simply borrowing to maintain an artificially inflated level of consumer spending. In America in this decade, there is no equivalent to an expanding railroad system, or a new steel industry -- only higher levels of consumer spending, in comparison to the country's total income, than ever before. The nation's new fiscal policy is not borrowing against the future earning power of its new industries, for there are none. It is mortgaging the living standard of future generations of its citizens. And it is eroding the economic basis underlying America's ability to be a leaders in world affairs.

* * *

Thank you, Mr. Chairman, for the opportunity to present my views to the committee.

The **Chairman**. With that, you are a tough act to follow, but you are being followed by somebody that can follow a tough act.

Mr. Burstein, we are very anxious to hear from you now.

STATEMENT OF DANIEL BURSTEIN, JOURNALIST AND AUTHOR, WEST REDDING, CT

Mr. **Burstein**. Indeed a tough act to follow, but I will do my best.

Mr. Chairman, and members of this distinguished committee, first of all, let me commend the chairman and all of you on the hearings you have been holding recently. Your July discussions on the state of America's financial services industry and the competitiveness of our industrial base, combined with what is being put on the table here today and tomorrow, reflects what I think is an earnest attempt to rise above partisanship, to dispense with the narrow focused, knee-jerk, special interest, now-now politics that have been responsible for much of America's failure to respond to the great international competitiveness challenges we face.

I sense you are trying to think more deeply, more broadly, and more globally, about how we deal with these challenges in the future and I sincerely support that effort.

I have prepared a rather detailed analysis in response to the questions you posed for today's agenda. With your permission, I would like to submit it for the record.

The **Chairman**. We will make that a part of the record, yes.

Mr. **Burstein**. I apologize for the length of that document, although I would like to encourage you to read it.

The **Chairman**. It will be read with care and interest.

Mr. **Burstein**. As a father of a 13-month-old son, I have put not just my head, but some of my heart into this discussion, which I believe centers not so much on what kind of an America we expect to wake up to tomorrow, but what kind of future my son, your children, and your grandchildren will inherit.

Let me now try briefly to summarize and highlight a few points from the material I have prepared. I have argued that Japan has obtained a disproportionate share of global financial power, and could therefore tilt the history of the 1990's and the early 21st century toward Japanese leadership.

"Financial power" can be a vague term. My efforts to quantify it, to point out for example, that all 10 of the world's 10 largest banks today are Japanese, or that Japan is today the wealthiest nation in asset terms, with over $44 trillion accumulated in national assets—these facts often sound startling to those who do not know them.

The **Chairman**. Can I get you to pull the microphone a little closer? I just want to make sure that everybody in the back of the room who is here can hear this, because these are such stunning facts.

Mr. **Burstein**. The implications, however, of what Japanese financial power means are best illustrated by the fleeting glimpses we can already catch of it in action right now. Let me just give you a few examples.

I was in Tokyo last month, and woke up one morning to the morning papers with the news that Sumitomo Bank and Sanwa Bank had decided they did not like the terms of the United Air

Lines leveraged buyout, and had thus decided to offer only $1 billion in financing for the deal, instead of the $3 billion that the American dealmakers were hoping to find in Japan.

The result of that perfectly reasonable business decision by two Japanese banks in Tokyo triggered last month's Friday the 13th mini-crash on Wall Street, in which $200 billion in New York Stock Exchange value evaporated overnight.

I would not assert that there was any Japanese conspiracy or political decision to use Japan's powerful financial card. Rather, I would call your attention to two observations. One, Japan's financial power is now so great that routine decisions taken in Tokyo set the agenda for American financial markets. Two, having witnessed Japan's ability to roil our markets so massively, unintentionally, we in this country would be well advised to consider what might happen should interests in Japan ever decide to apply similar financial force intentionally to achieve political or economic gain.

Another simple example. You are all aware of Sony Corporation's recent decision to purchase Columbia Pictures for $3.4 billion. Sony has made no bones about the fact that it intends to use Columbia's vast film library as well as its film and TV-making operations as a software laboratory to complement the hardware Sony is developing for high-definition television.

You also all know that when representatives of the American electronics industry came here to Washington this spring believing that they needed some kind of Government support to jump-start their efforts, they asked for about $1.5 billion in Government support to seed a competitive American entry into the nascent HDTV industry. That proposal, as I understand it, has essentially been rejected.

Various studies since have suggested that in these times of government budget deficits, it would be a mistake to invest heavily in such an unknown and unproven technological gamble as HDTV.

So here, we get another insight about Japanese financial power. A single Japanese corporation, Sony, is able to take an HDTV related gamble that costs $3.4 billion, without its balance sheet even noticing the impact. The mighty U.S. Government, on the other hand, cannot afford to spend less than half that sum on the attempt to ensure that American companies have a place in the HDTV race of tomorrow.

Now, this is what we are seeing today. Let me walk out a little bit further and note what I think is the most important thing on this issue to note. That is, the institutionalization of Japan's financial surpluses have created the conditions for Japanese industries to become super-competitive in the 1990's.

By "super-competitive," I mean so strong that they threaten not just to out-sell the competition or gain percentage points of market share, but threaten to wipe out the competition completely.

The first thing to understand here is that the mix of Japan's high domestic savings rates and extraordinary financial surpluses, with stringent anti-inflation measures in that country and a still closely-regulated banking system, keep the cost of capital in Japan very low. It is estimated that Japanese businesses raise money at an average after-tax cost of less than 2.5 percent; while American businesses face rates nearly three times higher.

Our stock market, whose role I understand from economics textbooks is to provide a vehicle for helping enterprises raise investment capital to grow and expand, seems to have ceased to fulfill that function. For the first 8 months of this year, according to a recent study, American businesses raised only 10 billion new dollars from stock issues. During that same time, Japanese business raised $120 billion, 12 times as much, through new stock issues.

Consider for a moment the competitive implications of a Japanese business world that is able to finance much of its expansion through cost-free stock issues, and still more through low-cost debt issues, facing off with an American business world that is barely able to issue any new stock at all, and that must finance most of its growth through high-priced debt offerings.

You can see why it is relatively easy for Japanese managers to continue their long-term focus, investing in new plants, new capacity, global expansion, new R&D, new business lines, and new equipment. Similarly, it is relatively difficult for American managers to justify such investments, because of the high cost of raising capital to fund them.

As a result, new Japanese capital investment in 1989 will be greater in absolute terms than new U.S. capital investment, in a country with half our population. Now, those investments will take some time to be realized: factories have to be built, new machines are being designed, et cetera. But I expect that in the 1992-95 period, we will see the full effects of what is now the world's greatest capital spending boom taking place in Japan.

If you think we have a problem competing with the Japanese now, I would advise you to contemplate what the mid 1990s might look like, if we do not begin to respond.

I hope I am making clear that I am of the opinion that much of our Japan problem is really an America problem, that we ought to be capable of solving by ourselves. Nevertheless, there is an extremely important Japan part of the Japan problem. And in my assessment, forces within Japan today are not only not helping the situation, but they are worsening it and hastening the day when an American political backlash is finally triggered.

I could give many examples, but to focus on the one with which I think you are all most familiar, the trade issue, there is no reason—and I underline, no reason in the world—for Japan, with all its wealth, with its booming domestic market, with its vast new economic security, not to throw its doors wide open to foreign participation.

It is intolerable that we have to be in the position of negotiating, pleading, lobbying, pressuring, just to get the tiniest, most grudging administrative measures to improve foreign market access in Japan. As a world leader, as an economic and financial superpower, and as a long-time beneficiary of the free trading system maintained largely by the United States for the last two generations, Japan ought to be taking leadership in energetically opening its markets at its own initiative so that the rest of the world can benefit from the Japanese miracle as well.

I am not saying that Japan has made no progress in market opening, but Japan has not seen fit to willingly take the initiative to do all it can. Instead, it seems content to continue amassing as much of a trade surplus as possible.

I would like to believe that Japan is being uncharacteristically blind to its own long-term interests by not acting more forcefully to take measures that address American fears. I would like to think, as many experts do, that it is only a matter of time before Japan realizes that it really is a rich country now, not a poor one any more, and can afford to be more generous, open, and fair-minded than it has been in the past.

I am afraid, however, that such a view would be naive. A more likely explanation of Japan's continued unwillingness to take positive action is this: Having, A, gained long experience with America's wavering political leadership and our lack of ability to follow a concerted strategy for any length of time; and B, having become convinced that America is in decline, and will increasingly need Japanese capital so badly that we will accept it on whatever terms it comes; the Japanese believe they can get away with constructing a more tightly controlled, more profitable, more mercantile, and of course more self-interested method of exercising world leadership than the American post-war model.

I think you are all aware of the American attitude in the 1950's and 1960's: that the world gains and America gains from American efforts to develop access in this country for foreigners. Maybe some of you even know the stories about how Eisenhower and Dulles lobbied this Congress and lobbied Government agencies to help Japan develop exporting industries, and to find incentives to bring Japanese products into the American market.

I am not saying that the American world view was not self-interested. But our belief that a more prosperous, more developed economic world ultimately benefits American interests, is at odds with the Japanese belief about how to approach economic development internationally today.

The good news is that in the last 2 years a sleeping America has woken up from what I believe were Reaganomic-induced dreams, and realized that serious problems lie ahead. The bad news is that we remain focused on defensive measures: Super 301, anti-dumping cases, structural talks with the Japanese towards opening markets, et cetera.

At best, these can produce modest, positive, short-term effects on the American competitive position. But such measures fail to address the underlying problems. For that, we need an approach that puts America on the offensive, with creative, new domestic solutions.

Thank you for your invitation to participate today at this hearing.

The CHAIRMAN. That is a wonderful summary, and an important one, and we want to come back as soon as we finish the presentations and we want to get precisely into the question of: what should we do, and how should we do it, in terms of changing these trend lines?

[The complete statement of Daniel Burstein follows:]

STATEMENT BY DANIEL BURSTEIN

(author of YEN! Japan's New Financial Empire and Its Threat to America)

Submitted for the record to the
United States Senate
Committee on Banking, Housing and Urban Affairs
at hearings November 14, 1989

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I. The #1 Priority: The Need to Think Long-Term

Mr. Chairman and Members of the Committee,

First of all, let me commend the Chairman of this committee and all of you on the hearings you have been holding recently. Your July discussions on the state of America's financial services industry and the competitiveness of our industrial base, combined with what is being put on the table here today and tomorrow reflects an earnest attempt to rise above partisanship, to dispense with the narrow-focused, knee-jerk, special interest, now-now politics that have been responsible for much of America's failure to respond to the great international competitiveness challenges we face, and to think more deeply, more broadly, and more globally about how we will deal with these challenges in the future.

I heartily endorse that approach. When I discuss U.S.-Japan competitiveness issues in public forums, I am invariably asked, "What is the #1 thing we can do to reverse the current situation?" My version of the #1 priority is one that requires neither legislation nor funding. It entails no negotiations with the Japanese nor is it likely to produce any adverse reaction in Japan or among our other trading partners in the global economic village. The #1 priority is that as a nation, as a social-economic-financial-technological-political system, we must bring an end to our malignant focus on short-term interests, short-term rewards and short-term solutions. We must shift our horizons instead to thinking, leading, planning, building, creating--and when necessary, sacrificing--for the long-term well-being of ourselves and our children.

When you begin to think long-term, you understand that America must raise its private savings rate, lower our consuming Federal budget deficit, and decrease excessive use of high interest rate corporate borrowings in order to have the supply of domestic capital necessary for the long-term investment we must make in future industries, badly-needed infrastructural improvements and other capital expenditures.

When you think long-term, you begin to realize that however many instant billionaires are created by speculative stock markets, managers focused on quarter-to-quarter profits, highly-leveraged corporate takeovers and a rapid-fire Mergers & Acquisitions industry, we are witnessing not the competitive restructuring of American industry but a suicidal dismemberment of the very companies, sectors and industries in which America now has global competitive strengths.

When you think long-term, you realize that while open markets, free trade and free investment are noble goals, the United States needs to be more careful about encouraging the one-sided exploitation of our markets and economy without progress towards similar access from our partners.

When you think long-term, you must wonder if it is a good thing for the U.S. financial services industry to become penetrated in such a concentrated way by foreign banks and brokerage houses that Japanese institutions are now often the dominant forces in our government bond market, or that (at least according to some estimates) Japanese institutions will control 25% of American bank lending in the next decade.

When you think long-term you begin to question whether it is advisable to believe that the "free market" alone should determine such important elements of our economic life as currency and interest rates--especially when those "free markets" turn out to be incredibly thin casinos made up of an extremely limited number of players, many of whom with vested interests not necessarily similar to our own.

When you think long-term, you begin to notice how much the shape of global economic life has changed since we adopted our basic world view towards international economic matters in the post-war period (at a time when the greatest economic competition in the world was the one between domestic American companies) and you run hard up against our deeply entrenched assumptions about such issues as anti-trust, government's role in influencing the private sector's agenda, the adversarial nature of American government-business-labor relations, tax neutrality and a whole series of other questions. You begin to realize that the Reagan Era prescription for dealing with Japanese competition--demanding that Japan raise the value of the yen, liberalize its capital markets, reduce trade barriers to the import of manufactured goods and stimulate its domestic economy--was so conditioned by the realities of a different age and a different American role in the world that Japan was able to fulfill almost this entire bill of particulars with the chief result that the Japanese side became still more competitive and the American side still less so.

As a matter of fact, if you think hard enough about the long-term interests of America, it becomes apparent that we are simultaneously losing our global abilities to compete in today's large-scale industries where America once led the world as well as in tomorrow's incipient industries, many of which have been based on American research and innovation, and many of which have long been viewed as our future trump cards.

When you think long-term, you realize that our inconsistent, incoherent and frequently contradictory approach to global trade issues continues to deliver us poor results in negotiations with our partners, while the assiduous use of an intelligent, coherent long-term trade strategy by the Japanese and others continues to enhance the very advantages they have in the structure of international trade which we are seeking to make more equitable.

And when you think long-term, it becomes obvious that as a nation we are engaging in what amounts to a national psychological denial syndrome--allowing ourselves to squander precious political energy on emotional and highly personal issues about flag-burning, abortion, and the private lives of our political leaders, while systematically ignoring the profound economic challenges we face in the world and the badly-needed political debate about ways of addressing them.

There are many ways to explain Japan's relentlessly increasing competitive abilities--which I will today dub "super-competitiveness" (a term I shall discuss later). Similarly, there are many ways to explain the erosion of America's competitive capabilities, a process which forms a nearly-perfect mirror image of Japan's successes. But the most important thing to understand is that despite inordinate inefficiencies, waste, bureaucracy, stifling hierarchies, and other problems endemic to Japan, the contemporary Japanese social-economic-financial-technological-political system is structured in such a way as to emphasize long-term planning, long-term efforts, long-term goals, and ultimately, long-term rewards. Conversely, in America today, despite our enormous national assets, our vast resources and our wondrous virtues as a people, the American social-economic-financial-technological-political system has come to be skewed in such a way as to encourage us to consistently choose what looks good in the short-term, even when it threatens our long-term future.

I wish to emphasize that I do not believe the Japanese are supermen: every time I have to pass through the maddening chaos of Narita airport in Tokyo, every time I visit a Japanese company and find a slew of bright, college graduate young women consigned to pouring tea and operating elevators, every time I get a glimpse of the corrupt smoke-filled rooms of Japanese politics, every time the exit tray of my Japanese-made photocopier machine in my home-office breaks, and every time I hear one of the arrogant, racist or America-bashing comments that increasingly pepper the discourse of the Japanese elite these days, I am reminded of the imperfections in the surface calm of Japanese society, and of deep fundamental problems that lie below. Indeed, Japan's population is graying, its consumers are becoming more demanding, its internal debate about assuming the burdens of global leadership is becoming more complex, its gap between the rich and the rest is growing, its women are beginning to ask for greater opportunity, its illegal immigrant population is putting new pressures on a country that has always thought of itself as homogeneous, and its best and brightest young people no longer plan to spend their entire lives with a single company or government ministry. Japan, in short, will have plenty of problems to cope with in the years ahead.

And I wish to emphasize that I do not believe the American case is hopeless: We not only still lead the world in quantitative measures ranging from GNP to consumer market size to scientific breakthroughs, we lead in most qualitative respects as well: we remain the most creative, most dynamic, most mobile, most flexible society in the world, offering more people higher levels of personal freedom, opportunity, prosperity and choice than anywhere else in the world or than any time in modern history, for that matter.

But my forecast is that Japan, despite its many problems, will continue to grow from strength to strength, while the United States will continue the process that is now upon us of slow attrition and unraveling of the basic ingredients that have historically made our society great, strong, and competitive. This forecast is likely to remain accurate so long as Japan clings to its long-term orientation and we cling to our infantile fascination with the short-term.

Having a long-term focus, I might add, is not some sort of inscrutable Asian characteristic. It is as American as apple pie. Most of our American history is imbued with the long-term vision--from the very way the founding fathers went about constructing the American democracy itself in the 18th Century, to the exploration of the West and the building of the railroads in the 19th century, to the Wright Brothers, Henry Ford and the other pioneers of American innovation and industry in the early 20th century, through Roosevelt's New Deal and the way Truman and Eisenhower went about building a safe, stable and prosperous global peace in the aftermath of World War II. From the visionary zeal with which John F. Kennedy talked about putting a man on the moon, to the similar virtuous passion with which the Rev. Martin Luther King Jr. expressed his dream for the success of the long, uphill climb for racial equality in America, we were, as recently as the 1960s, still a nation that believed in working consistently toward achievement of long-term goals.

We are not that nation any more. Over the last generation, but particularly in the 1980s, we have ceased to be that nation. Indeed, the President himself admits that he lacks "the vision thing." Time Magazine pictures a teary-eyed George Washington on a recent cover and asks, "Is Government Dead?" The magazine's headline writer acknowledges the painful truth, "Unwilling to lead, politicians are letting America slip into paralysis."

If I am not mistaken, in conducting these hearings, you Senators are seeking ways to end that paralysis and ways to restore long-term vision to the American political modus operandi. Let me again encourage and support you in that effort, and now turn to some of my personal perspectives on what is happening in the U.S.-Japan economic competition today and what may happen in the 1990s.

II. Glimpses of Japan's New Financial Power

I have argued that financial resources have replaced natural resources as sources of geopolitical power and influence; that financial power has become the most important kind of power in the world today--far more important than military power, ideological power, or even manufacturing power--and that the fact that Japan has obtained a disproportionate share of global financial power will fundamentally tilt the history of the 1990s and the early 21st Century towards Japanese leadership.

Let me remind you first of all of a few facts:

* All 10 of the world's 10 largest banks are today Japanese. The biggest American bank, Citicorp, is comparable in its deposit base only to a relatively minor Japanese bank.

* The Tokyo Stock Exchange surpassed the New York Stock Exchange in the total market value of its listed companies two years ago. Now, even the far, far less-important Osaka stock exchange--a backwater in the Japanese business world--handles a daily volume greater than London, a place we continue to believe is a major global financial center.

* When the 1980s began, Japanese stock markets represented 17% of world stock market capitalization, while the United States represented the lion's share at 55%. Today, those figures are almost completely reversed--Japan stands at 46% of world; the U.S. at 27%.

* The United States is no longer the world's richest nation. Japan is today the wealthiest nation in the world, with over $44 trillion represented in the value of its land, factories and financial assets, compared to roughly $36 trillion for the U.S.

* The stock market capitalization of Japanese financial institutions is typically 20-30 times greater than their American counterparts; in the global financial services competition where access to equity capital is critical, a Nomura Securities or Sumitomo Bank is in that sense 20-30 times more powerful than a Merrill Lynch or a Citicorp.

* The real estate value of Japan, about the size of California, is greater than the real estate value represented by the entire land area of the United States.

* Japanese companies, which have made about $60 billion in direct investments in the U.S. to date, now own about 2% of U.S. corporate assets and employ close to 250,000 Americans. By the year 2000, some experts predict a Japanese-owned sector of the American economy representing 10% or more of corporate assets and employing one million+ Americans. It is said that there are some 50

Congressional districts in which Japanese investment is a noticeable force in the local economy.

Bearing those facts in mind, let us take just a few glimpses of what Japanese financial power in action looks like:

* I was in Tokyo last month and woke up one morning to the news that Sumitomo Bank and Sanwa Bank had decided they didn't like the terms of the United Airlines Leveraged Buy-out, and had thus decided to offer only $1 billion in financing for the deal instead of the $3 billion the American dealmakers were looking for from Japan. The result of that perfectly reasonable business decision by two Japanese banks to withhold $2 billion in expected financing for the deal triggered last month's Friday the 13th mini-crash on Wall Street in which $200 billion in New York Stock Exchange value evaporated overnight.

To go back a little further, I think all of you on this committee are aware of the line of reasoning advanced at one point by Treasury Secretary Brady and other analysts of the 1987 stock market crash: The first domino in the chain reaction that ultimately caused the 508 point Dow-Jones meltdown of October 19, 1987 was the decision by a group of large Japanese investors to move out of U.S. government bonds owing to their fears at that time of further precipitous dollar depreciation. The Japanese moved out of bonds, the yields on bonds shot up over 10% as a result, and American institutional investors decided to vacate the stock market for the sunnier climes of guaranteed 10% returns in the U.S. government bond market, causing the stock market to crash stupendously.

In neither the 1987 case nor the 1989 case is there evidence of any Japanese malevolence, conspiracy or political decision to use Japan's powerful "financial card." Just simple, reasonable, intelligent business decisions. My point about these incidents is two-fold: 1) Japan's financial power is so great that decisions taken in Tokyo now set the agenda for American financial markets and 2) Having witnessed Japan's ability to roil markets so massively unintentionally, we, in this country, would be well-advised to consider what might happen should interests in Japan ever decide to apply similar financial force intentionally for political or economic purposes.

* I am sure you all noticed the acquisition of a 51% interest in the Rockefeller Group by Mitsubishi Real Estate. This, of course, is just one of many "trophy"-style Japanese real estate investments in this country and around the world. From Waikiki's hotels to the Arco Center in downtown Los Angeles to Tiffany's in Manhattan, Japanese companies have assiduously gobbled up the best addresses in the United States, not to mention on Australia's Gold Coast, in the City of London or in the French wine country.

I find the economics of Japanese real estate investment not especially threatening. The Japanese can't take the buildings with them; employment patterns are not much affected; no strategic technology is at stake and, at least so far, Japanese real estate investors have a good record of paying top dollar, managing buildings well, and investing for the long-term in needed repairs and renovation.

So why is real estate such an emotional issue? Why were New Yorkers so upset when they learned that a Japanese company had acquired a majority interest in the parent company of Rockefeller Center? Because real estate is visible psychological territory. The Japanese buy-up of American real estate graphically symbolizes what the average American feels is a loss of control over his own country and his own economy. The skating rink in Rockefeller Center is more visible and more intelligible than computer chips or Treasury bonds. Quite rightly, the man in the street senses something is wrong with his own country when it used to be the Rockefellers that symbolized world wealth and power, and now the Rockefellers appear as small fish being eaten up by the Mitsubishis.

Take a walk around Fifth Avenue and 57th Street in New York next time you are there if you haven't recently--and watch the teenage Japanese girls scooping up Tiffany jewels, Hermes scarves, and Chanel dresses that are the envy of even the most affluent women in New York. There is a faint but distinct rumble of neo-colonialism in this particular snapshot of the U.S.-Japan relationship, with Americans beginning to feel themselves the colonial subjects. With that syndrome comes an undercurrent of jealousy, xenophobia and ultimately, I suspect, political backlash.

* You are all aware of the Sony Corporation's recent decision to purchase Columbia Pictures for $3.4 billion. This deal is interesting for many reasons, but the aspect that interests me the most is this: Sony has made no bones about the fact that it intends to use Columbia's vast film library as well as its film and TV-making operations as a "software" laboratory to complement the "hardware" Sony is developing for High-Definition Television (HDTV). You also all know that there has been much political controversy this year over HDTV and what the United States government and private sector ought to be doing in this field. I happen to believe Sony and the Japanese are right--that HDTV's potential is enormous and that it could prove as important to future technological developments as the personal computer was to the technological revolution of the 1980s. But HDTV's ultimate impact is unknown and unproven. When representatives of the American electronics industry came to Washington in May with a proposal that involved some $1.5 billion in various kinds of government support to seed a competitive American entry into this nascent industry, the Commerce Secretary, among others, essentially turned it down. Various studies have since come out suggesting that in these times of government budget deficits it would be a mistake to invest $1.5 billion in such an unknown and unproven technological gamble.

So here we have another insight about Japanese "financial power": A single Japanese corporation, Sony, is able to take an HDTV-related gamble that costs $3.4 billion without its balance sheet even noticing the impact. The entire, mighty U.S. government, on the other hand, finds it too expensive to spend less than half that sum to attempt to ensure that American companies have a place in this race.

* I know all of you are weary from the debate over the FSX issue, but it will soon be rekindled in a new form much further from your influence or control. The Boeing Corporation, invariably cited as one of America's great companies, possessor of excellent technology, still one of the world's greatest manufacturing concerns, and certainly among the healthiest contributors to the positive side of the U.S. trade account, has indicated recently that it is seeking financial support for developing its next generation of civilian aircraft from three of Japan's heavy industrial companies which have long been trying to get into the global aircraft manufacturing business. Boeing finds it more convenient to raise capital in Japan through a deal that will inevitably involve considerable technology-sharing and fostering of the Japanese side's long-term abilities to compete in aviation than to go to the domestic debt or equity markets. These kind of deals have been aptly described as "Faustian bargains." For the sake of convenient short-term capital, Boeing is walking down the road of selling its technological soul. I have no doubt that by the early 21st Century Japan will be a highly competitive producer of state-of-the-art aircraft. Whether Boeing will then be able to compete successfully with Mitsubishi Heavy Industries remains to be seen.

* While we are on the subject of high-technology, which I think everyone agrees is critical to America's economic future, let me also remind you of one of the most classic examples of how Japanese financial power combines with American short-term thinking to produce results dangerous to this country's long-term future. It is widely believed that the supercomputer business is an important industry of the future and that American supercomputers are still superior to Japanese models, although the Japanese models are coming on faster and stronger. In the last few years, the U.S. has even made the Japanese refusal to buy American supercomputers a significant bone of contention in bilateral trade talks. Early this year, there were two American companies in the supercomputer business, Cray and Control Data. In April, Control Data dropped out completely, saying it could no longer afford the $100 million a year losses it was suffering--and saw only intensified Japanese

competition and greater losses down the road. In an amazingly candid statement of the facts, Control Data chairman Robert Price admitted at the time, "We have greatly reduced the U.S.'s long-term capabilities of competing with the Japanese. But that's not my problem any more."

The Japanese were shocked to hear this news. Spokesmen for Hitachi, which is also in the supercomputer business, wondered out loud how Americans could drop out of the competitive race over measly sums like $100 million losses--didn't they realize the future profits they were giving up? Didn't they understand the future technological breakthroughs that will accrue to those who persist in this business?

More recently, Cray has decided to split itself in half and restructure the company in order to keep its appeal on Wall Street where it was in danger of losing favor. It may now become more short-term profitable at the expense of spinning off its integrated infrastructure.

The lesson is clear: with their corporate wealth, the behemoth, diversified, integrated Japanese electronics companies like Hitachi can afford to ignore $100 million losses on supercomputer divisions as good investments for the future. Similar losses in this country cause companies with leading-edge technology to choose self-destruction.

* The European Community is actively at work on its project to achieve a single unified market by the end of 1992. This effort, which got off the ground just a few years ago, was inspired at least in part by a fierce European desire to prevent Japanese industry from dominating the European market in the way the Europeans saw Japan beginning to do in our country. The irony is that 1992 has turned out to be a beacon, not a barrier to the Japanese. And as Japanese manufacturing companies have rushed into the United Kingdom building a European beachhead with new investments, new technology and new jobs to offer, even the French

and the Italians--who have been the most concerned about the Japanese threat--now realize they must revise their closed-door policies, or else see the benefits of Japanese investment flow only to Mrs. Thatcher's England.

* We all know that Japan has no oil and that this is one of its great strategic weaknesses. But that situation is rapidly changing. With vast capital reserves to invest in an otherwise-depressed global oil market, Japanese oil companies in just the last few years have plunged into oil exploration, leasing and pumping activities at more than 90 locations in 20 countries. Already, Japan is getting 10% of its oil from Japanese-owned or leased fields and plans by 1995 to derive a third of its oil from such sites.

* While American agricultural producers have busied themselves in the last few years fighting for the opening up of Japan's highly-protected agricultural markets, Japanese companies have busied themselves buying prime ranches, feed lots, wheat fields and orchards from California to Western Australia. By the time the Japanese domestic food market really does open up, much of its supply will come from Japanese-owned agricultural ventures abroad.

* The managers of large Japanese institutional portfolios complain that they have so much money to invest they can't find sufficient places to put it. Until now, they have been content to buy our Treasury bonds, invest in our stock markets and buy some of our real estate and some of our companies. They have also diversified into similar activities in Europe, Canada, Australia, Southeast Asia and other places deemed investment-grade. But slowly, Japanese investors are beginning to look for more diversity--and perhaps places where their investments will be more welcome and gain them more influence. I believe it is only a matter of time before the Japanese become major players in the opening up of the Soviet and East European markets and economic frontiers. A savvy European diplomat I know in Tokyo has described the Russians as "beggars at the gates of Japanese capital," with the Japanese watching, waiting, and looking for the opportune moment to open those gates.

When they do, we will see an interesting new shift in the world balance of power.

III. The Institutionalization of Japan's New Financial Power

When I first began writing and speaking about Japan's new financial power, I met up with many skeptics who acknowledged the unprecedented appearance of Japanese wealth, but said it was a one-time blip on the charts owing to the extreme revaluation of the dollar and the yen.

Today, however, Japan's new financial power is in the process of being institutionalized. Yes, one reason for the sudden domination of the "top 10 world banks" list by Japanese institutions had to do with the doubling of the yen's value from 1985-7, but that no longer matters. The strong yen is here to stay. Its value is no longer a statistical aberration as some economists believed two years ago. It is a fact of life.

Among the many sins of Reaganomics, few were as devastating to America's competitive posture as the decision to try to redress the trade deficit through currency juggling. Specifically the decision made by the Reagan Administration prior to the Plaza meeting of 1985 to launch a broadside attack on the value of the U.S. dollar--and to arm-twist the Japanese and the West Europeans into supporting us in this suicidal behavior--has proven to be the most significant catalyst speeding the ascendancy of Japan and the decline of the United States. The very Reagan administration which seemed so partial to the imagistic trappings of American wealth and power seemed not to realize that it was taking the knife to the jugular vein of American wealth, reducing by half the value of every American dollar-denominated asset in the world and doubling in value every yen-based asset in the hands of our greatest competitors. In order to accomplish this dubious goal, the very Administration which professed to believe in the sanctity of "free markets" had to carry out a massive, systemic two-year long program of government intervention in the currency markets.

In hindsight, as we continue to run a $50 billion annual trade deficit with Japan, it ought to be obvious that even with such radical currency rate sleights of hand, we could not hope to solve the problems creating the trade deficit in the first place. The 1985 idea that the Japanese would buy much more from the U.S. if American goods became cheaper and that Americans would import less from Japan if Japanese goods became more expensive proved to be an economist's ivory tower fantasy vision of the free market, completely divorced from how trade takes place in the real world. The chief result of driving down the dollar was not improved American trade competitiveness but the turning of America into a bargain basement for foreign acquirers, the lowering of the barriers to entry to foreign ownership interests in the heart of the American economy and financial system, and the enriching of Japan with financial assets far beyond its wildest dreams.

I favor a stronger dollar (around 200 yen) as a means to curb some of the excessive economic imbalances that are being created around us. But even if we had a consensus that we wanted to go in that direction--and we surely don't, because the Treasury and the Fed seem to still believe that a dollar over 150 yen will adversely hurt the trade balance--it would now be extremely difficult to undo what the Reagan Administration has done. That is because the Bank of Japan and the Ministry of Finance in Tokyo, which initially feared a strong yen back in 1985 and were quite reluctant to have Japan assume that burden, now realize that a strong yen is much to be favored over a weak yen; that Japan is much better off with a weak dollar than a strong one. True, some Japanese exports have become less competitive. But by buying imported raw materials denominated in weak dollars with strong yen, by active restructuring of Japanese industry and by moving manufacturing offshore to lower wage areas--the U.S. included--Japanese business has been able to turn the situation to its advantage. The restructuring process--especially the move offshore--has been greatly eased by the strength of the yen. Whereas in 1985 the Bank of Japan intervened in currency markets to support the dollar, today we find it driving the dollar down every time it lifts its head towards 150 yen.

The astronomical values in Japanese financial markets are similarly becoming institutionalized. Western analysts say that the Japanese stock and real estate markets defy both logic and gravity. Some of them keep predicting crashes. But it should now be apparent that Japanese markets defy only Western-style logic and Western-style gravity. Tokyo didn't crash when invited to do so by the world crash of 1987--it recovered quickly and soon reached record highs. It didn't crash when the Emperor died or when one Prime Minister after another resigned--instead, it climbed to record highs. It didn't even get nervous at the prospect of the Madame Doi's Socialists winning parliamentary elections--again, it rose to record highs. And, most recently, Tokyo shrugged off Wall Street's 7% drop on October 13. In fact, Tokyo's confidence was credited with keeping the rest of the world from falling into another abyss. American analysts say "fundamentals" don't justify these values. I say that with Japanese stocks accounting for nearly half of all world stock market capitalization, it is perhaps time for American analysts to consider the limitations of the American data base from which they draw their knowledge about what comprises "fundamentals."

The U.S. trade deficit with Japan is also being institutionalized. Continuing to fear anything that smacks of industrial policy, the U.S. has not taken initiatives to utilize what is now our weak-dollar driven low global cost of labor to expand capacity in the new and critical industries. If we don't have a domestic U.S. fax machine industry or a domestic U.S. home video camera industry, and a giant upsurge takes place in consumer demand for these products, all that happens is Japanese exports to the U.S. soar higher, even at their strong yen-based prices.

Another great myth worth exploding here is that of "transplant" factories alleviating the trade deficit. There are now about seven Japanese-owned auto plants in operation in the U.S. and they are doing quite well. Most are extremely modern, state-of-the-art, and ultra-competitive. In fact, they are consistently expanding production even as the Big Three American manufacturers shut down U.S. facilities in the face of industry-wide over capacity. Yet while I expect 1990 Japanese production inside the U.S. will be higher than ever, the dollar volume of Japanese cars exported from Japan to the United States will also be higher than ever, perhaps dramatically so, based on the success of the new luxury models introduced by Nissan and Toyota which sell for three to four times as much per unit as traditional Japanese exported cars.

The U.S. trade deficit is now being compounded by the even worse current account deficit, and this will become a bigger problem over time as Japanese companies begin to repatriate their profits from the American market causing another major drain of dollars out of the system.

IV. Japan's Emerging "Super-Competitiveness" in the 1990s

The institutionalization of Japan's financial surpluses has created the conditions for Japanese industries to move from being intensely competitive to being "super-competitive" in the 1990s. By super-competitive I mean so strong that they threaten not just to out-sell the competition or gain percentage points of market share, but threaten to wipe out the competition completely.

The first thing to understand here is that the mix of high domestic savings rates and extraordinary financial surpluses with stringent anti-inflationary measures and a still-closely regulated banking system keeps the cost of capital very low in Japan. It is estimated that Japanese business raises money at an average after-tax cost of less than 2.5%, while American business faces rates three times higher.

Our stock market, whose textbook role in the economy is to provide a vehicle for helping enterprises raise the investment capital needed to grow and expand, seems to have ceased to fulfill that function. That, by the way, is an issue I would certainly encourage all of you on this committee to explore in greater depth. For the first eight months of this year, according to a recent study, American business raised only 10 billion new dollars from new stock issues. During that same time, Japanese business raised $120 billion through new stock issues.

Consider the competitive implications of a Japanese business world that is able to finance much of its expansion through cost-free stock issues and still more through low-cost debt issues, facing off with an American business world that is barely able to issue any new stock at all and must finance most of its growth through high-priced debt offerings. You can see why it is therefore relatively easy for Japanese managers to continue their long-term focus--investing in new plants, new capacity, global expansion, new R&D, new business lines, new equipment including the latest robots and computers. Similarly, it is relatively difficult for American managers to justify these investments because of the high cost of raising the capital to fund them.

As a result of these and other factors, new Japanese capital investment in 1989 will actually be greater in absolute terms than new U.S. capital investment--and that's in a country with half our population and still only 60% of our GNP. On a per capita basis it is estimated that in 1990, Japanese business will invest three times what American business will invest in new equipment and capacity. Many of those investments take time to be realized--factories have to be built, new machines designed, etc. But by 1992-5 we should be seeing the full effects of what is now the world's greatest capital spending boom taking place in Japan.

Other elements will contribute to the "super-competitiveness" of Japanese business in the 1990s:

* For years, Reagan administration trade negotiators demanded that Japan stimulate its domestic economy--and now it has, with the world's biggest consumer boom. That boom is now turning the

domestic Japanese market into a driving force shaping the global economy. HDTV, for example, is already in limited broadcast use in Japan. The Tokyo auto show earlier this month featured so much exciting new technology that two million Japanese turned out to see it--and it caused veteran auto industry analysts from this country to observe that Japan was taking leadership from Detroit in the last few areas of design where it had previously lagged.

* For the last five years, Japanese businesses have been acquiring assets abroad, but they have yet to fully integrate and utilize them. Over the next few years, we will begin to see Japanese companies gain synergies and economies of scale from their new acquisitions, as well as more direct channels of market access.

* As the biggest foreign investor in the most dynamic growth market of the world--East Asia--Japan is rapidly obliterating U.S. business influence in Korea, Hong Kong, Singapore, Taiwan, Thailand, Malaysia and China. While there is reason to be excited about new markets in West Europe after 1992 and in East Europe as it becomes de-communized, no one analyzing growth opportunities should forget that it is the East Asian market which will grow the fastest, and that Japan is extremely well-positioned to take advantage of such circumstances. While U.S. auto companies are going to undergo another painful shakeout in the coming years, as a result of overcapacity, Japanese companies will be building cars for the one market of the world that still lacks sufficient capacity.

* Partly through foreign acquisitions and partly through the change of focus that greater wealth has permitted Japan, its companies will increasingly prove that they can compete not just in "hardware"-intensive businesses, but in service businesses, creative businesses and other "software"-intensive activities. Whereas Japanese business once relied on American or European partners to supply the "software" component, they will be increasingly self-reliant in this regard in the future.

V. The "Competitiveness Deficit"

The essence of the U.S.-Japan economic imbalance is not a trade deficit but what I call a "competitiveness deficit." The trade deficit is only the symptom; the disease has to do with how American business, industry, finance and society runs. Let me enumerate a few of the facets in this competitiveness deficit:

* I cannot emphasize strongly enough the advantage Japanese business has in working from a low cost-of-capital environment. Perhaps an analogy will help: go out and look at what kind of home you can afford with an 11% mortgage--and then compare it to what you could afford if your interest rate was only going to be 3%. At 11% you settle for what is inevitably inadequate space and amenities; for 3% you get your dream house. Our competitiveness deficit here derives from a combination of our low savings rate, the drainage of capital out of our system in the form of the trade deficit, the high U.S. government budget deficit and high corporate borrowing demand. Most of our country's great economic successes of the 20th Century were achieved in a low cost-of-capital environment--roughly similar to what Japan enjoys now. It is very hard to invest and build for the future when you are looking over your shoulder at making the next junk-bond interest payment.

* The demand for short-term profits and quarter-to-quarter gains mandated by the structure of American stock markets is a complete losing strategy for enhancing long-term global competitiveness. The patient nature of Japanese markets, the stable system of cross-shareholdings and other features of the Japanese system allows Japanese companies to fulfill their goals and strategies in a planned, steady fashion.

*The role of government is an important issue as well. The nature of Japan's "industrial policy" may now be undergoing considerable change, but there is no doubt that intervention and leadership form the Japanese government--subtle thought it may be at times--is a critical factor in shaping and launching new industries, promoting exporting capabilities, protecting sectors of the domestic market, maintaining rock-solid financial stability, mediating excessive competition among domestic industries, maintaining stable employment levels, utilizing tax policy to aggressively support targeted industries, etc. Thus while our political leaders are busy spreading the gospel of free markets and free trade, our competitors are using intelligent, consciously-devised, government-led strategies to better manage their trade policies and the functioning of their markets.

* Japan's much-vaunted consensus and social cohesion is another major competitive asset stacking up against our increasingly frayed social fabric. The fewer days lost to labor strife, the lower costs to Japanese business of a low-crime environment, the greater skills-training of the workforce, the more detailed attention to quality of less-alienated workers, the markedly diminished need for high executive compensation schemes, and the less adversarial nature of Japan's business and financial structure, are all pieces of a Japanese system that is proving itself more efficient than its competition.

* This is not the committee hearing to dwell on the crisis in American education, but suffice it to say that if we continue to send our kids to school 60 fewer days than the Japanese do; if we continue to de-emphasize math & science while they emphasize these building-block skills for the information age; if they continue to graduate 97% of high school entrants with 99% literacy while we only graduate 60% with 90% literacy, we are going to be at increasingly serious deficit in our ability to compete.

VI. The "Japan" part of the "Japan problem."

As I hope I have made clear, I am of the opinion that much of our "Japan problem" is really an "America problem" that we ought to be capable of solving by ourselves. Nevertheless, there is an extremely important "Japan" part of the "Japan problem." In my assessment, forces within Japan today are not only not helping the situation, but worsening it, poisoning the trans-Pacific atmosphere and hastening the day when an American political backlash is finally triggered. I'm sure that many of you have read the translation of the book The Japan That Can Say No which I understand is an underground best-seller here in Washington. You will certainly have seen that in this book, Shintaro Ishihara, a maverick, yet well-known and much-admired Japanese politician, not only expresses a frustrated, angry, condescending and arrogant view towards the United States, he goes so far as to encourage Japan to use its high-technology as a bargaining chip in U.S.-Japan relations and to offer Japanese defense-related microelectronics technology to the Russians as a way of showing Americans who's in charge of the world balance of power now.

Although I find this book extremely interesting, it does not really represent a new trend. In my book, YEN! which was published over a year ago and researched in 1986-7, I documented many similar views among influential Japanese--from the head of Nomura's New York operation who proposed a plan whereby Japan would share California with the United States, to the leaders of the emerging Japanese military-industrial complex who favor an independent Japanese military policy. Even among America's best friends in Japanese leadership circles--those who have a genuine, warm-hearted affection for American things and who still believe in the important role the U.S. played in supporting the Japanese economic miracle--most are convinced that America's days as a world-leading power are numbered. They see that our ability to compete economically is in long-term if not permanent decline and that Japan must assert its own interests more forcefully if it is to avoid being swept up in the centrifugal force of American self-destruction.

As a result, a great complacency (at best) and outright antagonism (at worst) has set in in Tokyo about doing anything more to improve U.S.-Japanese relations. I believe the consensus in Japan erroneously holds that Japan "has done enough." And, while we in this country often fail to realize just how much progress there has been in Japan, let me make it quite clear that Japan has not done anywhere near enough.

On the trade issue for example, there is no reason in the world for Japan, with all its wealth, economic security, and booming domestic market, not to throw its doors wide open to foreign participation. Critical as I am of our American trade negotiating strategies--and critical as I am of some of the products our companies sometimes hope to sell the Japanese, I know for a fact that there are numerous outstanding American products, services and businesses which either cannot enter the Japan market at all or else are systematically excluded from the mainstream of business. It is intolerable that we have to be in the position of negotiating, pleading, lobbying, pressuring, in the first place--just to get the tiniest, most grudging administrative measures to improve foreign market access to Japan. As a world leader, as an economic and financial superpower, and as a long-time beneficiary of the free-trading system maintained largely by the United States for the last two generations, Japan ought to be taking leadership in energetically and creatively opening its markets and its business practices so that the rest of the world can benefit from the Japanese miracle as well.

Even if the Japanese private sector is reluctant to "buy foreign," the Japanese government, as one of the world's largest procurers of a variety of goods--including satellites, computers, telephones and other high-tech gear American companies still manufacture at high-quality specifications and at world-leading levels of technological performance--could be playing an agenda-setting role, perfectly commensurate with its normal function in Japanese society.

The fact that Japan has not seen fit to willingly take initiative in opening its markets, but seems content to continue amassing as much of a trade and current account surplus as possible while giving in only to the most demanding voices on the most isolated, specific issues, would suggest that the outside world does have something to worry about in an increasingly Japanese-dominated world order.

On the "burden-sharing" issue, it would seem once again that given Japan's vast financial surplus and excellent technology, Japanese leaders would be doing much more to aid world growth and development. Although Japan is earmarking greater funds for the third world--and is trying to participate more actively in the IMF where the British have been blocking an expanded Japanese role--Tokyo has not yet found a way to qualitatively upgrade its role commensurate with its resources. Japan is not only not leading such global causes as protecting the environment (as would befit a newly-emerged financial superpower amid the backdrop of the late 20th Century) Japan continues to be one of the most rapacious exploiters of third world environments. Southeast Asian jungles are deforested for the Japanese chopstick and furniture markets. Brazilian highways, financed by Japanese banks, are blazed through the rain forest to open up Pacific ports to trade with Japan. Despite some progress and the beginnings of an environmentally-conscious movement in Japan, the Japanese have thus far not seen a serious problem with continuing to provide the world's largest market for elephant ivory jewelry or to slaughter whales for the delicacy of eating "whale bacon" in high-class Japanese restaurants.

On the investment issue, it would seem that Japan ought to be smarter and more sensitive to the dangers inherent in today's almost exclusively one-way flow of capital. Japanese financial institutions are able to dominate American government bond auctions, but American institutions must still fight for crumbs of the Japanese bond market. Japanese companies freely buy American companies whole, while Americans face enormous difficulties--indeed near-impossibilities--buying companies in Japan. Japan's ownership stake in the American economy continues to grow in geometric proportions year-by-year, while American companies in Japan, unable to resist the premiums of today's Japanese financial markets, have actually been selling off what limited ownership interests they acquired in a bygone era.

Much of this situation may be the inevitable product of macroeconomic factors, but the inability of the Japanese side to control its desire to acquire American trophy properties and companies, the lack of Japanese interest in finding creative ways to help foreigners invest in Japan, and the frequently unilateral (as opposed to joint-venture or partnership/alliance) approach to Japanese investment in the U.S. are all signals that cause great unease in this country. Similarly, some activities of Japanese companies in the U.S.--buying parts and components from Japanese, rather than American suppliers, maintaining a Japanese-only policy when it comes to upper management, concentrating in geographical areas and business sectors so heavily as to become dominant forces, resisting representation of workers by American labor unions, tending to discriminate more than the rest of American business against minority and women workers, housing Japanese executives posted to the U.S. in exclusive communities with exclusive golf clubs and exclusive Japanese schools--all of these activities inspire American concern, worry and downright fear about Japan's role in the United States. These concerns are growing even when data indicate that Japan's role has thus far been quite positive in raw economic terms.

I would like to believe that Japan is being uncharacteristically blind to its own long-term interests by not acting more forcefully to take measures that address American fears and to launch initiatives that show Japan to be more generous, open and fair-spirited. But I am afraid a darker explanation is more likely: Having gained long experience with America's wavering political leadership and our lack of ability to follow a concerted strategy for any length of time and having become convinced that America is in decline and will increasingly need Japanese capital so badly that we will accept it on whatever terms it comes, the Japanese believe they can get away with constructing a more tightly controlled, more profitable, more mercantile, and of course, more-self-interested method of exercising world leadership than the American post-war model of leadership. In the American model, we too sought our self-interests, but believed they would be best developed and protected through active American measures to expand global prosperity. I think you all know the stories about how Eisenhower and Dulles lobbied the Congress and U.S. government agencies to help Japan find ways to develop its exporting industries in the 1950s at a time when Japan was in trade deficit with the U.S. and appeared to have no products it could export competitively in world markets. The American line of reasoning was that the cause of the free world, and ultimately the American cause, would be better served by a stronger, more successful Japan.

There are many leaders in Japan who do believe, in like manner, that the Japanese cause would be well served today by a stronger America and greater economic development elsewhere in the world. But I am afraid they are in danger of becoming a minority. Our trade negotiators are rapidly helping them become a minority with our maddening product-by-product, sector-by-sector approach, rather than looking at the large-scale issues and seeking a renegotiation of the whole U.S.-Japan relationship on equitable terms.

VII. America is Waking Up

Change is beginning to take place in the U.S. intellectual climate on issues relating to Japan, competitiveness and the American future. Much of what I have said today would have been considered shocking just one or two years ago. Today, I think it is fair to say that this commentary resonates compatibly with a wide variety of experts who have reached similar conclusions. The very economists who were the architects of the plan to attack the dollar in order to bring down the U.S. trade deficit now admit they misestimated the ability of currency rate juggling to solve the problem. Negotiators who thought they were making headway in cracking open Japanese markets now admit the problems are more intractable than they first appeared. A growing community of American CEOs worries publicly that America is losing industries, markets, and the future to Japan because of our short-term mentality, our lack of attention to manufacturing detail and the crisis in our educational system.

In a bold 1989 cover story entitled, "Rethinking Japan," Business Week put these stark words in black and white on its cover: "After years of haggling, the U.S. still runs a $52 billion annual trade deficit with Japan, and Japanese society remains closed in crucial ways. As a result, a radical shift in U.S. thinking about Japan is under way. This revisionist view holds that Japan really is different--and the conventional free-trade policies won't work. Once, such views would have been dismissed as 'Japan-Bashing,' but now they have an intellectual base." In a similarly striking cover story, The Atlantic featured an analysis by James Fallows called "Containing Japan." The message: "Japan's runaway economy will harm the rest of the world if some limits aren't set."

These are not just journalistic themes. Your hearings are another kind of reflection of the new concern about these issues. So are private sector initiatives such as what IBM is doing. Among the freest of American free market companies, IBM has taken the lead in creating a consortium of domestic American chip manufacturers called U.S. Memories, Inc. to share technology and resources. Their stated intention is to keep an American presence alive in the memory chip business.

It is no longer just Democrats calling for new policies on Japan and American competitiveness. Leading Republicans, including some of Ronald Reagan's most enthusiastic supporters, now believe that American leadership was asleep at the switch in the 1980s. Earlier this year, I spent several days here in Washington discussing these very issues with Republican leaders like Bob Dole, Ted Stevens, Newt Gingrich and many others in meetings organized by Rep. Frank Wolf of Virginia. I must say I not only received a sympathetic ear, I was impressed with the depth of concern I heard. I think Frank Wolf speaks for many Republicans when he says--as he often did introducing me to his Republican colleagues--"I'm a free-trader. I voted against protection for the textile industry. I voted against the Gephardt Amendment. But now I think this country has got to act fast if we don't want to lose everything we stand for." In the statements of U.S. Special Trade Representative Carla Hills, Commerce Secretary Robert Mosbacher and leaders of the Defense Department's influential Advanced Research Project Agency one can sometimes now detect a hint of support for government-promoted policies to encourage new industries, coordinated inter-agency initiatives to achieve better results on trade, and other ideas that were anathema to the Administration in the Reagan years.

On the level of symbol, all of these are positive signs about the direction the country needs to move in. Yet they consistently smack of the "too little too late" syndrome. One week Secretary Mosbacher says the U.S. must find the way to seed the new industries of the future; shortly thereafter he tells the electronics industry that Washington has no intention of subsidizing a significant U.S. push into HDTV. We invoke the beginning stages of the Super 301 process with great fanfare--and much to the chagrin of our trading partners--but several months later, no one I know of in any of the targeted countries is seriously worried that the U.S. will take meaningful action.

As economist David Hale has warned, implementing a few pieces of managed trade/industrial policy solutions in an ad-hoc patchwork manner is potentially more dangerous than laissez-faire. Without a consistency to the strategy, and without the pieces working together, the United States could conceivably end up antagonizing Japan and our other trade partners with policies that appear protectionist and yet still fail to revitalize domestic industry.

The man in the street is dangerously far ahead of the politicians on these issues. Public opinion polls reveal that more Americans now fear Japanese economic competition than Soviet military aggression. The vast majority see further Japanese investments in the U.S. as a bad thing. Americans have become so worried about Japan that they even overstate the case--most believe Japanese real estate holdings are ten times greater than they actually or that Japan is the world's biggest economy, even though it still remains second to the United States.

In this highly-charged and emotional atmosphere, there are two entirely different "Japans" being discussed. One is the real Japan that still carries out certain patently unfair policies, keeps some of its domestic markets closed, and remains mercantilist, nationalistic and self-interested even while talking about contributing to an interdependent world. A certain amount of "tougher" negotiating with the Japanese can be useful here, provided the toughness is well thought-out and linked to a broad strategy of where the U.S. would like to go in its overall relationship with Japan.

But there is another Japan in this discussion that exists only as a metaphor for our own American competitiveness problems. True, Japan keeps its construction business closed, its agricultural imports unfairly taxed and uses 1001 subtle practices to keep foreigners out of the mainstream of its financial sector and off its retail shelves. But it is not Japan that is forcing America to engage in the orgy of deficits and debt that drives our cost of capital out of competitive bounds. It is not Japan which is demanding that American business operate only for short-term reward. And it is not Japan which is responsible for the crisis in our schools.

The good news is that in the last two years, a sleeping America has woken up and realized that serious problems lie ahead. The bad news is that we remain focused on defensive measures--Super 301, anti-dumping cases, structural talks with the Japanese towards opening markets, etc. At best, these can produce modest positive short-term effects on the American competitive position. But such measures fail to address the underlying problems. For that, we need an approach that puts America on the offensive with creative new domestic solutions.

In the last four years, Japan completely transformed its economy, eradicating most of its low wage industries, moving to high value-added sectors, capitalizing on the strength of the yen, deploying its trade surplus for strategic results and internationalizing its economy to a considerable, if still not sufficient degree. In the United States, meanwhile, we spent the first two of those four years believing there was no problem and doing nothing. We then spent the next two coming to a recognition that there was indeed a problem. But we have yet to meaningfully act.

The 1990s are upon us. Japan will continue to transform itself, renew itself, internationalize, globalize, and in doing so, evolve ever-greater ambitions for its economy, its companies and its people. There are signs the Europeans are trying to take the same road with their bold vision for 1992.

And the United States--what is our vision for the future? It remains an unanswered question. We have so many resources as a nation that it now appears we can go on selling off our assets, piling up our debts and watching our companies lose leadership and market share for several more years without triggering a visible crisis. We are unlikely to encounter another single apocalyptic event to goad us into action as the October 19, 1987 stock market crash almost did. The Bush Administration contains a competent nucleus apparently capable of managing American decline more slowly, steadily and with fewer shocks than the Reagan team.

The prospect then is for slow attrition--a decade of reckoning, not a day of reckoning--in which Japan emerges in the year 2000 as the most powerful, dynamic, advanced and wealthy nation on earth, and the United States emerges not impoverished but weakened, exhausted, polarized, and far less influential than today.

The problems seem daunting. The surprise is that the answers are not so complex. On that score, hopeful signs have emerged from the discussion in the last two years. Whether it is the recent Made in America study published by M.I.T.'s Commission on Industrial Productivity, or the Cuomo Commission Report: A New American Formula for a Strong Economy, or any number of similar reports, the general outline of what needs to be done is basically clear: Reduce American indebtedness, particularly the Federal budget deficit and bring the cost of capital down. Invest more in productive capacity, infrastructure, new technology and civilian R&D. Reward such investments with favorable tax treatment. Save more and reward savings with better tax treatment. Promote exports. Curb excessive speculation, paper parasitism and the greed factor in the churning of capital markets that sets the short-term agenda for American business. Develop a means for government to set the agenda for advancing certain key industries, not necessarily with big cash outlays or large Federal programs, but by using government's visible leadership platform. Overhaul education so that all of America's citizens can graduate from high school with functional literacy, the basic skills needed to find employment, and a minimal set of shared values that binds us together as Americans. Develop a sensible trade policy, coordinate the activities of multiple U.S. government agencies in support of it, and use an acceptable range of carrots and sticks to ensure the cooperation of our trading partners in building a global environment that doesn't unfairly disadvantage America.

In a certain sense, America has woken up. The answers are relatively straight-forward. Implementing the solutions, however, is, of course, a far more difficult process. In a best-case scenario, that's what leadership in the 1990s will be about.

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The **Chairman**. Mr. Chimerine, we are delighted to have you. You have been here before. You have got two tough acts to follow, but you are fully equal to that assignment. So we would be delighted to hear from you now.

STATEMENT OF LARRY CHIMERINE, SENIOR ECONOMIC ADVISER, W.E.F.A., BALA CYNWYD, PA

Mr. **Chimerine**. Thank you, Mr. Chairman.

I am delighted to be back. I, too, would like to congratulate you on holding these hearings, because in my view this issue, the issue of industrial competitiveness, is the most important economic issue of our times. I think it is probably the most misunderstood, as well. I am hopeful that these hearings can spur some action and lead people to realize that we do have a serious problem in this country.

I suppose I should also congratulate you, I would like to believe, for your selection of witnesses for this hearing.

Let me start by citing some of the ramifications that have already occurred of what I think has been a major change, a major deterioration, in the relative competitive position of the United States in world markets. Then I'd like to discuss why I think there is still a sense of complacency in this country, and talk about what has caused the problem in my judgment, and where we should go from here in terms of addressing some of the basic fundamentals.

It is not too difficult to see signs of the problem everywhere. We see it in massive trade deficits. The United States has traditionally been a trade surplus country, at least after World War II; but as everybody here knows, in the last 7 or 8 years we have had massive trade deficits.

The United States' share of worldwide production has fallen in almost every manufacturing industry, and fallen dramatically, during the past 10 years. Import penetration has spread throughout the United States. It is no longer in autos and shoes from Brazil, and perhaps steel; in virtually every single industry we have seen a giant increase in import penetration.

As everybody knows, and has been discussed already in the last few moments, we now are the biggest debtor nation in the world, after being the biggest creditor nation for many, many years. Foreign purchases of U.S. assets, whether it be real estate, equity, or other financial instruments, has sky-rocketed in recent years.

And as Ben Friedman mentioned, real wages have stagnated in the United States. I think these and many others that I could cite are clear ramifications of the changing competitive role, the negative changing competitive role, of the United States in world markets during the past 10 years. My concern, quite frankly, is that, if we do not shift gears in the United States and change some of the fundamental trends that I will refer to in a few moments, these will all continue and perhaps even worsen as we go through the 1990's.

All of these ramifications I cited alone are an outgrowth of the basic problem; namely, as I said earlier, that there has been a deterioration of the competitive position of the United States in the world economy. In my view that deterioration can be best summarized as follows.

For many years, this country had an enormous advantage over our foreign competitors in three key areas: first, in product quality; second, in technology; and third, in productivity. And of course, these are somewhat interrelated; they are not mutually exclusive.

We can start, for example, with technology—it is clear that the United States was the undisputed leader in technology in the world for many, many years. We were not only responsible for most, if not all, of the new scientific breakthroughs, but we were the ones that used them for developing new products, and for improving the production process in most industries. And these new innovations of all types obviously gave us an enormous competitive advantage.

Second, and partly related to that, in industry after industry throughout almost the entire post-war period, the United States had average productivity levels far higher than our competitors overseas. In some cases, the difference were as much as 40, 50, or 60 percent or even higher. These productivity advantages partly reflect innovation, and probably a whole host of other factors.

Third, for many years I think it was clear that we also produced better-quality products in the United States. It is difficult to measure, but at least the perception if not the reality was that U.S. products were clearly of superior quality to those produced by our foreign competitors.

The simple truth is, in almost every single industry, the advantages that we as a country had in those key areas no longer exist, or at a minimum, have been reduced dramatically.

Lets again start with technology. Now when we develop our technologies in the United States, they get shifted around the world almost instantaneously. Everybody has access to them. And other countries, particularly the Japanese, have shown themselves to be more adept than we are frequently in taking these new breakthroughs and developing new products from them. And of course, many new scientific breakthroughs are now taking place in other countries. This was essentially unheard of 15 or 20 years ago. Thus, our lead in technology has diminished.

Second, in most industries the productivity gap that I referred to before has largely eroded. In several cases, it has been completely eliminated, and in fact in a number of industries average productivity levels in the United States now have fallen below the levels in some of our foreign competitors.

Again, we can cite a number of reasons for it. Some of it is just the pure catch-up, particularly in those countries that were devastated during World War II and whose infrastructure was significantly destroyed. They had to go through a catch-up process.

But regardless of the reasons—and I will cite some others a little bit later—it is clear that we do not have the productivity advantages in most of these industries that we used to have, and in many we have actually fallen behind.

Third, certainly the perception is that in many of these industries, particularly in consumer goods, we do not have the product quality advantages that we used to have. Many foreign producers make products as well as we do now, and in some cases perhaps better.

In my judgment, that is the essence of the change in competitiveness. Yes, fiscal policies in the United States have worsened the problem. And part of the relative change has been a catch-up phenomenon that we have seen around the rest of the world. Some of it is welcome; it is in our interests I think to see the rest of the world improving like they have over the past 10 or 15 years. But I think, when it gets right down to it, it is fair to say that a substantial part of the problem has been the flattening out of productivity in the United States during the past 15 years.

The truth is that we have made ourselves an easy target for foreign competitors, because we have stopped improving the way we did in the 1950's, 1960's, and early 1970's. And even with all the investment overseas and all the other things that they have done to improve themselves, they probably would not have achieved the competitive advantages they have today if our own rate of improvement in the past 15 years had continued at the rate that we had experienced during the 1950's and 1960's.

So it is a complex problem. And as I think Mr. Burstein has mentioned, part of it is here, made in America. But I think the fundamental conclusion has to be that we do have a competitive problem largely resulting from the erosion of our competitive advantages in world markets, which we previously used to upgrade living standards in the United States by increasing wages—some of that through the collective bargaining process—and by creating millions and millions of high-paying corporate jobs all of which we could afford when our own productivity was rising rapidly and when it was much higher than it was in other countries.

Fundamentally, what has happened during the 1980's is that we no longer have the productivity advantages to justify the high cost structure we have put in place in the United States. And that, too, has been a major factor in the competitive erosion that we have experienced during this period.

Now, why has there been such complacency in this country, despite what appears to be very serious problems—an erosion of competitiveness, lackluster productivity, big trade deficits, increased foreign ownership, and so forth. I think there are a number of reasons for this complacency, and all of them in my judgment are misguided. Very quickly, let me run through them.

First, there are many people who say, "Well, why worry about this? We have the longest peace-time recovery in history, despite this big trade deficit, despite our competitive problems." In fact, they claim that there probably is not a competitive problem; otherwise, we would not have experienced this recovery. And of course, some people attribute this recovery to a supply-side miracle, and extrapolate this kind of performance into the 1990's.

I think this is about the most dangerous conclusion that can be reached at the moment, because in my judgment what we have experienced in this country during the past 7 years is not a supply-side miracle, but a standard cyclical recovery coming from an extremely low base following the two back-to-back recessions in the early 1980's. The expansion has also been helped along by a number of temporary factors such as lower oil prices during most of the 1980's, lower interest rates, massive fiscal stimulus, incredible willingness of foreigners to lend to the United States, the willingness of individuals and corporations to go deep into debt to finance spending in this country, and so forth.

All of these factors which helped perpetuate this recovery in my judgment are at best temporary in nature, and in fact very likely will be counterproductive for the long term, as my colleagues on the panel have already talked about.

We are already beginning to see a sizable slow-down in economic growth in the United States, reflecting the fading-out of the cyclical factors, and second reflecting the fact that the temporary stimulants I talked about a few moments ago are also fading out. As a result, it is extremely dangerous to extrapolate the performance of the last 6 or 7 years.

It sort of reminds me of the 1960's, when a different group of economists felt that we had the business cycle licked. We had a long expansion during the 1960's, as well. Well, we then had 4 recessions in the next 11 years, and stagflation through most of the 1970's, so I certainly would not extrapolate the recent performance.

Second, some people say, "Well, maybe we did have a competitive problem, but it has disappeared now," because manufacturing productivity has improved a little bit during the past few years, because we are seeing an increase in manufacturing output again (at least until a few months ago), and because the trade deficit has come down. So even if we did have a problem, we have taken the right steps in this country, and we no longer have a competitive problem in world markets.

I am baffled how anyone can reach that conclusion, for the following reasons: First, manufacturing productivity did tick upwards a little bit in the mid-1980's, but we are now beginning to see that a lot of that reflected one-time adjustments, such as plant closures and cooperate layoffs in many industries. But these are one-time adjustments, rather than sustainable improvements in productivity.

Second, many companies have shifted union job functions, especially support type functions, to other suppliers. It makes their productivity look better, but of course on an economy-wide basis you do not get any benefits. We are seeing this in a whole host of manufacturing industries.

Third, even with the modest improvement in productivity in manufacturing in the mid-1980's, it lagged behind, and continues to lag behind, the rate of growth in many of our competitor nations. And finally, during the past 18 months or so, the growth in productivity in the United States has begun to slow down again, and is now roughly in line with the average we have had over the past 15 years.

So I do not think you can use the recent productivity statistics to conclude that the problem has been solved.

Fourth, the trade deficit has come down, yes. But instead of being incredible, it is now just enormous. We are still running a deficit at something like $110 to $115 billion a year, and even worse, over the past 6 months there are signs that it has flattened-out again. Furthermore, most of the improvement we have gotten over the past year or two has come from a weaker dollar and cost cutting, rather than from any improvement in the underlying fundamentals. It is occurring at the expense of living standards, rather than improving living standards, and that is the ultimate objective, in my judgment.

So again, in sum, I do not see how any one can reach the conclusion that trends or developments in recent years suggest that either we have nothing to worry about, or that we did have something to worry about but the problem has been solved.

There are other arguments that are made also to deny the competitive problem in this country. For example, some people attribute our trade deficits to fast economic growth, leading to rising imports, and that is what caused the trade deficit, rather than a fundamental competitive problem in this country.

But we are now beginning to see, now that economic growth is flattening out in the United States and we still have these giant trade deficits, that faster growth in this country relative to countries overseas accounted for only a small part of U.S. trade deficits during the 1980's.

Second, while I agree with Ben Friedman that large budget deficits, by creating conditions which produced an over-valued dollar and other factors, and by directly stimulating demand, also contributed to the trade deficits in this country in my judgment, they did not cause the lion's share of them, as we are beginning to see now that the dollar has come down about 50 percent on a trade-weighted basis during the past 4 years.

And there are other arguments as well—such as that we are not deindustrializing as a country despite the trade deficit, so that the problem is not serious. But as I think everyone knows, there was a very large increase in the demand for manufactured goods in this country in the 1980's. The only reason manufacturing as a share of GNP has not collapsed is because of that big increase in demand. We have satisfied an increasing share of that from overseas. If it wasn't for rising import penetration and weak exports, manufacturing as a share of the economy would have risen dramatically during the 1980's. It is our competitive erosion that prevented that from happening; furthermore, and as we are now beginning to see, we are beginning to deindustrialize as manufacturing output begins to lag behind the overall economy.

In my judgment, we began to see evidence of our competitive problems as far back as the mid-1970's, but they were hidden for several years by a number of factors. First, the dollar dropped sharply during the 1970's, preventing large trade deficits from developing.

Second, exports to OPEC countries during the last half of the 1970's were enormous as they began to spend their oil revenues, particularly on development and construction equipment. Much of that came from the United States.

And, third, our exports to Latin America were unsustainably high during that period, most of that financed by bank debt, by bank loans to Latin America.

Once those temporary forces started to peter out, we would have begun to see trade deficits in this country even without our misguided fiscal policies in the early 1980's.

So there is a competitive problem. It began as far back as 15 years ago, and in reality it is getting worse in my judgment.

What can we do about it? Well, I think the first thing to recognize is that the productivity problems that we have in this country are essentially multidimensional. No one has been able to isolate one factor that has caused the slowdown in productivity, and by the same token, I think it would be unwise to assume that there is any one button we can push that would accelerate productivity as we go through the 1990's. And, in my view, the only acceptable way to improve our competitiveness as we go through the next 10 years is to establish a dramatically improved trend in productivity in the United States.

All other solutions, in my judgment, will not produce the desired result of an improvement in trade and higher living standards simultaneously, and that is what the proper objective should be. Unless we improve our productivity our problems could become even more serious as we go through the 1990's because we are in real danger of falling further behind now that our cyclical recovery is slowing down, now that the Japanese are in the midst of a massive investment boom where they are essentially remodernizing their entire economy, now that Europe is integrating, which is likely to produce faster growth in productivity in that part of the world.

So if we don't get our productivity act together in this country, it is very likely that our underlying competitiveness will actually become worse as we go through the 1990's.

How can we achieve this goal?

I think the first question we have to ask is what is: What as a country do we have to do to achieve a faster trend in productivity, and what should the proper role of Government be in the process? I think we have to recognize that just because we did things in a certain way in this country 15 or 20 years ago doesn't mean that that is what we need to do in the future, particularly when we take into account the changed role of the United States in world markets.

Productivity is a multi-dimensional problem. We need to get the cost of capital down by lowering budget deficits, find ways to increase national savings, find ways to channel an increasing share of those savings into more productive investments; stretch out the planning horizon for most corporations; shift the focus away from financial transactions toward more real long-term investment; get the cost of health care down in this country; improve the quality of education; get back the leadership we used to have in nondefense R&D [which we are increasingly losing, particularly to the Japanese and the Germans]; etc.

And I think every one of these has to be addressed if we are going to see meaningful improvements in productivity in the United States. And, as I said earlier, we need to ask ourselves what is the Government's role in that process. Without strong national leadership, in my judgment, Mr. Chairman, it is not going to happen.

It is unrealistic, for example, to expect 15,000 school boards in this country to figure out how to improve the quality of education in order to make us more competitive in world markets.

It is unrealistic to address the budget deficit without strong Presidential leadership, and I could go down the list.

We are running out of time. I would be glad to discuss this more in the Q and A. But it is going to require a major national effort beginning here in Washington.

Thank you, Mr. Chairman.

[The complete prepared statement of Lawrence Chimerine follows:]

STATEMENT BY

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Congress of the United States
Senate Banking Committee
Washington, D.C.

November 14, 1989

My name is Lawrence Chimerine and I am a Senior Economic Advisor to The WEFA Group and an independent consultant as well. Prior to my current position, I was Chairman, Chief Executive Officer and Chief Economist of The WEFA Group before resigning those positions earlier this year. I am delighted to have this opportunity to testify before the Senate Banking Committee on the changing role of the United States in the world economy, and on the implications for future economic activity and living standards in this country.

In brief, I will make the following points:

Summary

1. There has been a major change in the U.S. position in the world economy, reflecting a decline in relative U.S. competitiveness in world markets. In my view, the advantages that the United States had over most of our international competitors in technology, product quality, and, most importantly, productivity, have largely been eliminated — in some cases, we have actually fallen behind. Most disturbing, while the narrowing of U.S. advantages in part reflects a natural catching-up of the rest of the world to the United States, we have made ourselves a relatively easy target during the past 15 years because of the near stagnation in our own performance during that time.

2. In my judgment, most of the internationally-oriented problems that have surfaced in recent years, such as massive U.S. trade deficits, the declining U.S. share of worldwide production in most industries, increased reliance on imports, the change from being a major creditor nation to the largest debtor nation in history, and the rapid rate of foreign purchases of U.S. assets, all are outgrowths of the fundamental change in competitiveness.

3. Despite some rebound in manufacturing and a modest decline in the trade deficit in the last few years, I firmly believe that the fundamental problem has not yet been solved. In essence, recent improvements primarily reflect temporary cyclical forces which are now winding down — the underlying fundamentals, particularly with respect to productivity growth, remain very poor.

4. Unless some of the unfavorable trends are reversed and productivity growth accelerates on a sustainable basis, it is virtually certain that (a) any additional progress in reducing the trade deficit will be limited, and/or will require large additional cost cutting and dollar devaluation and/or sharp cuts in domestic demand and (b) real wages are likely to be stagnant for many years, preventing any meaningful improvements in living standards in the United States (this process appears to have already begun).

5. The potential stagnation in U.S. living standards is made even more likely by the growing burden of increasing foreign debt — unless those funds are channeled more into productivity-generating investments, producing faster economic growth in the future, the rising cost of servicing that debt will become a larger and larger burden for the economy, sucking out increasing amounts of income as we move through the 1990's. This too will place limits on future living standards.

6. In my judgment, therefore, the number one economic priority in the United States should be to improve the underlying trend in productivity growth. The evidence suggests that since no one factor is responsible for the slowdown in productivity growth during the last 15 years, a multi-dimensional approach will be necessary to speed it up. This will require (a) bringing budget deficits down to reduce the cost of capital; (b) changing budget priorities at the same time so that we spend more on building for the future rather than on current consumption; (c) finding ways to increase private savings, and to channel an increasing share of those savings into productive investments; (d) reversing the weak trend in non-defense research and development; (e) increasing the quality of education; etc.

Introduction

During the short span of approximately 10 years, the position of the United States in the global economy appears to have undergone spectacular changes. In particular, the United States has experienced massive trade deficits throughout the 1980's, after being a trade surplus country during most of the previous post-war years; in industry after industry, the U.S. share of world production has dropped markedly; import penetration has spread throughout the economy, after previously being significant in only a hand full of industries; the United States is now the world's biggest debtor nation, with the net debt position continuing to grow at an alarming rate (prior to the last several years, the U.S. was the biggest creditor nation in the world); and foreign ownership of U.S. assets of virtually all types is rising very rapidly. The natural questions are (1) what has brought about these dramatic changes, and (2) what are their implications for the future. In my judgment, the essence of the problem is the change in relative U.S. competitiveness in world markets -- in the section below, I will discuss those changes, and their likely implications unless major adjustments are made in the U.S. economy.

U.S. Competitiveness in World Markets

U.S. productivity and technology advantages were so large during the early postwar years that the United States was able to maintain dominance in world markets, and generate ongoing trade surpluses, despite funding much of the free-world's defense, despite having very open markets, and despite cultural and trade barriers which limited access to some other markets. However, even though U.S. manufacturing has remained relatively stable as a share of GNP, these basic advantages have been narrowed dramatically, primarily by rapid productivity growth among traditional foreign competitors, and by the emergence of many highly-productive new competitors in the last 15 years, reflecting: (a) the speedier transfer of U.S. -- developed technology to the rest of the world, (b) a more rapid rate of new innovation in many other countries than in earlier years, (c) a strong emphasis on product quality and design, (d) high saving and investment rates, (e) the rebuilding of World War II ravaged infrastructures with the most modern equipment (and the use of such equipment in the NIC's), (f) the increased mechanization of agriculture, (g) the lower base from which many foreign countries started, and (h) an emphasis on rapid growth, both domestically and in exports, in order to generate the profits necessary to fund additional investment, and research and development. During the same time, productivity growth in the United States was slowing relative to the earlier postwar years.

The net effect of these factors has been to dramatically narrow the differences in productivity and product quality which existed previously between the United States and older competitors, at the same time that a large number of new, highly efficient competitors emerged - in fact, average productivity levels in many tradable goods industries are actually now higher in Japan and some other countries than they are in the United States (although not on an overall economy basis, because U.S. productivity levels remain higher in various other industries). As a result, relatively high wage and capital costs in the United States can no longer be justified by productivity differences, and represent an enormous competitive disadvantage - the combination of these developments has caused a rapid shift away from U.S. dominance in world markets, with sharp declines in the U.S. world-market share for most manufactured and agricultural goods, massive trade deficits, and rapidly growing foreign debt. These trends have been aggravated by the enormous U.S. budget deficits and the overvalued dollar in the early 80's, and by the LDC debt crisis.

Most disturbing about the U.S. competitive problems in world markets is the changing nature of foreign competition. During the 1970's, Japan and many other countries began to compete successfully with U.S. companies on the basis of lower wages and, therefore, lower production costs; in more recent years, their competitive strengths shifted more toward product quality rather than just lower costs; and now, they are increasingly competing successfully on the basis of new products and new technologies.

The decline in fundamental competitiveness (i.e., in relative productivity), and its likely effect on future economic growth (to be discussed below), have been hidden or unrecognized because of the following:

1. **The manufacturing/GNP ratio (in real terms) has remained relatively stable, suggesting that the United States is not de-industrializing.** However, the stability of manufacturing output as a share of real GNP in recent years actually further demonstrates the erosion of U.S. competitiveness when it is viewed in the context of the rapid rebound in the demand for manufactured goods (relative to total demand) in the United States, reflecting the large turnaround in consumer durables, the procurement-dominated military buildup, and the tax-incentive-led pickup in investment in the early 1980's. The surge in demand for goods was so strong that it prevented the manufacturing/GNP ratio from declining despite the loss of U.S. market shares (and the related influx of imports and slowdown in exports) - without the change in relative competitiveness, the manufacturing output/GNP ratio would have risen sharply during the 1980's. This also explains why U.S. manufacturing output grew more rapidly than in the rest of the world during the initial stages of recovery - the U.S. market, in which the U.S. has a relatively large (but declining) share, has grown much more rapidly than markets overseas. Finally, maintaining a near-stable manufacturing/GNP ratio (the trend at cyclical peaks has actually been slightly negative) over the last 15 years has been possible only in part by a steadily declining dollar relative to most currencies during the 1970's, which offset some of the widening unit labor cost differentials at that time.

2. **The U.S. economy has grown more rapidly than most other industrialized countries during recent years - this is often cited as the primary cause of large U.S. trade deficits.** However, while faster economic growth in the United States has obviously increased the trade imbalance, it does not account for the sharp rise in import penetration rates (rather than just import levels), and the decline in U.S. exports in real terms between 1980 and 1987 (even though economic growth outside of the United States was been positive, although modest). These have combined to cause the sharp decline in the U.S. share of worldwide production in most industries referred to earlier, and in overall world trade, in the 80's. Furthermore, the U.S. trade imbalance continued to rise even as U.S. demand and overall economic growth slowed in 1985 and 1986, and has come down only modestly in the last two years despite a 50% decline in the trade-weighted value of the dollar.

3. **The onset of massive trade deficits has coincided with large budget deficits, leading many to conclude that the budget imbalance, by pushing up interest rates and the U.S. dollar exchange rate, is the dominant cause of our trade problems.** However, as best evidenced by the rapid rate of increase in the U.S. trade deficit with Japan, and the steady decline in the U.S. dollar relative to the yen and other industrialized currencies, our trade problems were developing well before the 1980's. The full extent of underlying deteriorating competitiveness at that time was temporarily masked by the surge in exports to Latin America (financed by unsustainable U.S. bank lending, much of it directly tied to exports), by rising exports to OPEC countries (in response to oil-revenue-financed development and construction programs), and by the relatively weak dollar. Large U.S. budget deficits have clearly made trade deficits worse, both by pushing up the U.S. dollar in the early 80's and by directly stimulating demand; however, increasing foreign competitive pressures would have occurred even in the absence of unbalanced U.S. fiscal policies.

4. **We have experienced a very long economic expansion despite large trade deficits, leading many to question whether such deficits are inherently bad and/or whether there has been any major change in U.S. competitiveness, and/or whether these trade deficits are just a minor side effect of the growth oriented supply-side policies enacted in the early 80's.** However, this expansion was not produced by a supply-side revolution, but rather by a large number of factors. **First,** the enormous fiscal stimulus injected into the economy by the massive net tax reductions enacted in 1981 and by the large military buildup have clearly been a factor in the recovery process. **Second,** the dramatic easing of monetary policy that was initiated in the summer of 1982 (as indicated by both declining interest rates and rapid growth in the money supply), was also a major contributor. **Third,** to some extent the recovery was purely cyclical, reflecting the large recessions of the early 1980's which created large pent-up demands and vast amounts of idle resources. **Fourth,** the favorable effects of the sharp decline in oil prices during the 1980's enhanced household purchasing power. **Fifth,** the longevity of the recovery is also in part the result of the change in sectoral mix, so that different pockets of strength emerged at different times to continue the expansion process. **Finally,** and most importantly, the length of the recovery period also in part reflects the incredible willingness of the economy to incur more debt and the willingness of foreigners to lend us that money at reasonable interest rates. Without this, the recovery would have been more sluggish and/or shorter.

Most disturbing is that we have deluded ourselves into thinking that our competitive and other problems are not serious because of the relatively long expansion -- however, it should be clear to all that we have essentially experienced a cyclical recovery helped along by the temporary forces described above, and that now these factors are becoming less favorable at the same time that the cyclical factors are petering out. There has been no supply-side miracle, as indicated by the following:

a. Despite the long recovery, average economic growth during the 1980's has been lower than in any other decade since World War II;

b. While the personal saving rate has increased a little bit in the last year or two, it is still far below earlier post war years;

c. Even some improvement in the mid 80's, net investment remains weak, despite the inflow of foreign capital;

d. While labor force growth has been relatively strong, this appears primarily due to flat real wages and social factors rather than supply-side factors;

e. Productivity growth has weakened again;

f. Tax revenues excluding social security continue to lag behind overall economic growth, despite supply-side promises;

g. Domestic and foreign debt levels have sky-rocketed, funding a significant amount of the recovery that we have experienced.

Implications for the Future

As mentioned above, there is absolutely no reason to believe that the long economic expansion still underway has resulted from any major transformation of the economy which has improved long economic prospects. In fact, quite the opposite is the case -- what we have essentially experienced is a long cyclical recovery/expansion from a very low base following the two back-to-back recessions in the early 1980's; sectoral factors have not improved during this period, and in some cases have actually worsened. This is highly significant because now that the cyclical part of the expansion is over, long-term factors will become dominant; these include the poor rate of productivity growth and our eroding competitiveness in world markets. Furthermore, it is unlikely that the United States will be able to continue the rate of debt accumulation that took place during the 1980's -- quite the opposite, already high debt burdens may also limit future economic growth.

I thus strongly believe that, in part because of our competitiveness problem, economic growth may be sluggish for many years into the future — recent data indicate that this process may have already begun. Such sluggish growth will be caused not only by continued very large trade deficits but because the ramifications of our competitive problems are likely to increasingly hold down domestically-oriented sectors of the economy also by squeezing real wages and by keeping real interest rates relatively high. The stagnation in real wage growth (which already appears to have begun), coupled with low saving rates, high debt burdens, and other factors, will limit the growth in consumer spending on a secular basis. Growth in the demand for durable goods will be especially sluggish because they are most sensitive to real income and debt levels.

Implications of Growing Foreign Debt

The merits of rapidly increasing foreign ownership of U.S. assets (especially Japanese ownership) are being increasingly debated, with some highly in favor and others extremely concerned. It seems to me the following points are the most relevant for this debate.

1. Such investment is absolutely essential in the short term while we have big budget deficits -- without it, interest rates would be much higher and economic growth much lower.
2. Some of the foreign investment is in the form of capital spending in the United States.

While these are favorable, it must also be clearly understood that there also are some long-term negative ramifications of the increasing share of foreign ownership of U.S. assets. These include the following:

a. While foreign ownership is still not high in relation to total U.S. assets, what is most alarming is how rapidly it is increasing -- if this trend continues, the ratio will become much higher in the years ahead.

b. Most disturbing is that despite the large influx of foreign capital and a significant increase in foreign direct investment in the United States, total net investment in the United States is still relatively weak. In effect, much of the foreign investment in recent years is financing large federal budget deficits, current consumption, and financial transactions rather then the type of investments that will speed up future economic growth. Thus, even if these funds are not pulled out of the United States, there will be some negative effect in the future reflecting the sharp increase in debt servicing that will occur -- this will suck increasing amounts of income out of the United States from total output levels that will not be significantly higher than they would have been without the foreign investment.

c. The increasing influence and ownership of foreigners in the United States is likely to result in some loss of control over our own destiny. In particular, it puts an added constraint on monetary policy, which is likely to mean somewhat higher interest rates than would have been the case in order to provide an attractive climate for foreign investment. Furthermore, increased foreign ownership probably means increased foreign control of technologies, distribution, etc., particularly when the high ownership rates in the United States are combined with their high levels of investment overseas.

d. The United States leadership role in world affairs will obviously be jeopardized by our continuing relative economic decline and loss of ownership of assets.

Thus, in my judgment, it is simplistic to assume that rising foreign ownership of U.S. assets is an unqualified plus for the U.S. on a long-term basis. Furthermore, whether it is good or bad, it will be necessary as long we continue to have massive budget deficits that have to be financed, and as long as we continue to experience massive trade deficits. In effect, we are borrowing the money from overseas to finance high levels of imports and high budget deficits in the United States. There is no way in my judgment that this can be described as healthy on a long-term basis. Thus, until our competitive situation improves and until our budget deficits are reduced, it is inevitable that foreign investment in the U.S. will continue to grow.

Prescriptions for the Future

The top economic priority for the rest of this century must be to accelerate the underlying trend in productivity growth from the dismal performance of the last 15 years. Productivity grew by an average of nearly 3% per year in the 1950's, 1960's and early 1970's; since 1973, it has decelerated to an annual average of less than 1%. As a result, average productivity is now over 20% less than it would have been had the previous trend continued. Many explanations have been offered for this near-stagnation in economic efficiency, but the obvious conclusion from the research that I and many others have done is that no one single factor, such as shifting demographics or any other relatively uncontrollable factor, is responsible. Rather, the evidence suggests that a multitude of factors, each making a relatively small contribution, are at fault. These factors include the need to absorb large numbers of relatively inexperienced new entrants into the labor force; an increasing share of business investment going toward energy conservation, environmental needs, and other relatively unproductive (although perhaps necessary) activities and needs; declining research and development; a substantial reduction in invested capital per worker; a shifting mix away from relatively high productivity sectors toward those with lower average productivity; a reduced focus on the importance of manufacturing, etc. Most disturbing is that overall productivity growth has been disappointing in recent years despite many favorable factors, such as declining oil prices, the relatively long period of economic expansion, the large amount of idle resources when the recovery began and widespread cost-cutting.

The dramatic slowdown in productivity growth is the root cause behind the major economic developments during the last 15 years. First, as discussed earlier, the competitive position of the United States in world markets had declined dramatically since the early 1970's, causing sharp declines in the U.S. share of worldwide production in most industries; gigantic trade deficits after many years of surpluses; and, our shift from being the world's largest creditor nation to its largest debtor in a matter of a few short years. This change in relative competitiveness primarily reflects a shrinking of U.S. advantages in technology, product quality, and mostly, productivity. In industry after industry, the gap in these areas has been narrowed by foreign competitors — in some cases, U.S. companies have actually fallen behind. And, most significantly, the slow growth in productivity in the United States made it relatively easy for foreign competitors to catch up.

Second, and directly related, real wages have essentially stagnated since the early 1970's, following an average annual post-war increase of 2.5% until then. Although partly due to oil-caused inflation in the 1970's, the major factors have been widespread wage restraint and the loss of many high-paying jobs (while most of the newly created jobs are lower-paying) that resulted from sluggish productivity growth and deteriorating competitiveness. The slowdown in real wages has meant that an increasing number of families have had to rely on a second income, cutting savings, and/or going deeper into debt in order to improve or just maintain their living standards.

A substantial acceleration in productivity growth is in essential if these trends are to be reversed, if the tradition of rising real wages and living standards in this country is to be restored, and if the current expansion partly created by a massive debt buildup and by rising labor force participation rates is to be continued. Higher productivity is also necessary if we are to address the enormous unmet needs that have been building, such as dealing with the drug problem, finding a cure for aids, etc. — only in a more productive society can we have the resources to meet these needs.

This, in my view, will require a major national effort. Unfortunately, the opposite seems to be occurring — not only are these unfavorable trends not receiving adequate attention, but if anything, a sense of complacency seems to have developed because of the decline in the trade deficit since early 1988. However, the trade turnaround has been small at best, and is primarily due to the weak dollar and cost cutting in U.S. industry (and thus is occurring at the expense of living standards) rather than reflecting any major change in fundamental competitiveness. Without such a change, real wage gains will continue to be weak, or nonexistent, at a time when an increasing share of U.S. incomes will be needed to service the enormous and still growing foreign debt — this combination would further jeopardize living standards in the future.

What is particularly disturbing is that the growth in manufacturing productivity has begun to slow in the last two years, following a surge in the mid-1980's. But this is not surprising since the early surge partly reflected widespread outsourcing of various job functions (and thus was not accompanied by a significant acceleration in economy-wide productivity growth), as well as many one-time factors such as plant closings and corporate staff layoffs, rather than ongoing improvements in manufacturing efficiency. What is needed is to produce a sustained period of accelerated growth in productivity, not just one-time adjustments, especially since the gains in efficiency in many of the countries we compete with still exceed that being experienced in this country. And, since the basic factors which influence long-term productivity are not improving, this is not likely to take place unless major changes in government policies, and in our priorities as a nation, are implemented. Furthermore, foreigners are not standing still — a major investment boom is now taking place in Japan, and Europe is rapidly moving toward integration. These trends will make it even more difficult for us to compete in the years ahead unless we address our own problems.

That is why I and a number of colleagues at Rebuild America, including Nobel Laureate Robert Solow, recently proposed a comprehensive strategy to boost productivity through increased private and public investment in physical and human capital. Essentially, we believe that the only clear way to produce the sustainable, ongoing increases in productivity that are needed is to increase our basic research, to embody new technology more quickly in our production facilities through a higher investment rate and a more long-term focus, and to educate and train our workers more effectively. Unfortunately, the recent evidence suggests that without a government-led national focus, adequate improvements may not take place, especially since the solutions, like the causes, must be multidimensional. Washington must play an important role in the process by mobilizing the private and public sectors on behalf of such an "investment economics" that raises the national savings rate, provides tax incentives for productive private investment, and boosts public investment in the workforce and cutting-edge industries in the 1990's.

Specifically, Washington should:

1. Set goals for savings, investment, R&D, educational quality, etc;

2. Focus attention on the importance of productivity in every segment of the economy, and help create an environment that favors real investment over speculation and financial transactions, and that moves us away from an excessive short-term focus toward a more long-term orientation.

3. And, most of all, promote policies which create the best possible business environment by:

    a. Reducing the budget deficit in order to increase national savings.

    b. Developing policies to ensure that the resulting increase in national savings is used wisely; e.g. for more productive investment and more research and development by the private sector.

    c. Adjusting spending priorities and the tax structure to promote future investment and growth.

    d. Bringing industry, government, labor and universities together for joint research and other cooperative efforts when appropriate.

    e. Forging government-business alliances to address specific economic problems.

    f. Reducing LDC debt to make those countries viable markets for U.S. products again.

    g. Being more forceful in opening up foreign markets to U.S. goods.

    h. Reversing the declining quality of education, especially in mathematics and science, in order to increase the skill levels of the labor force.

Much time has already been lost -- the Administration and Congress must begin to address these issues as soon as possible and give them the highest priority during the next few years, or the next generation, and those that follow, may suffer the consequences in the form of stagnant, or even declining, living standards.

The CHAIRMAN. Well, thank you. That is a terrific third part of the presentation this morning, and we are proceeding in a fashion to not use time limits so that each of you could make the summary statements that you felt were appropriate, obviously being an abstract of the broader materials that you have given the committee today.

I am going to very shortly yield to my colleagues because I want to get the discussion going back and forth here. We have had other members here. As you know, we have got a variety of things going on today in terms of the session in the House as well as a number of wrap-up activities going on here. The conference committee is meeting, for example, on reconciliation. I happen to be a member of that conference, and so there are reasons why other members have to be other places this morning.

I think you have done precisely what I expected you would do, and that is you have laid out here a presentation that in scope and scale and detail I think is the most important set of comments and revelations and insights I have heard anywhere this year in the Congress on anything, and it relates precisely to where we are and where we are going as a country as a whole.

I want to ask you each in a sense a yes or no question because I want to get a bottom line point on the table here.

I conclude from what each of you say in different ways that in fact there is an urgent national need to revise our overall national economic strategy, and by that I mean not just public sector but private sector. I am taking them together to say if you take America's strategy as a whole, public and private sector, I conclude from what you are saying that there is an urgent national need to revise our national economic strategy.

Would you agree with that conclusion, Mr. Friedman.

Mr. FRIEDMAN. Yes, sir.

The CHAIRMAN. Mr. Burstein.

Mr. BURSTEIN. Absolutely.

The CHAIRMAN. Mr. Chimerine.

Mr. CHIMERINE. Without question.

The CHAIRMAN. Well, it is very important that we establish sort of a baseline agreement here because there are other views out there that each of you have touched on that are quite different than that. I mean, I suppose the polar opposite view that has been popularized comes from the song "Don't Worry, Be Happy," and you know that has gotten a lot of circulation as a concept.

What I hear you saying is literally the 180-degree polar opposite of that notion, and that is we have got the most serious kinds of problems facing us in this changed world economy and time is running out. Time is running out.

I also conclude from what you have said that the longer we wait to make a serious set of adjustments, to go back and work out and put in place this urgent need for a changed national economic strategy, the longer we wait the more difficult it will be to respond. In other words, there is an enormous cost in the failure to understand what is going on and that every month and every year that ticks by without us going through the needed adjustments will make the problem far more difficult to solve. In fact, it may even take away—some of the options that are available to us today might not be there in three years or five years.

Is that also a correct conclusion?

Mr. **Friedman**. Yes, sir.

The **Chairman**. Mr. Burstein.

Mr. **Burstein**. Absolutely. I think it is very important to realize that there are people out there saying there is going to be this global boom forever, that history has come to an end, that the problems are being solved, and we don't have to worry.

It is interesting to me, that very song "Don't Worry, Be Happy"—I think the song writer was being ironic when he wrote the song, but it has become a motto for a certain way of looking at the world.

The debate is not about how well we live today. If you base your assumptions on how well we live today I would say you don't have to worry that much. We are having a debate about what the future is going to bring, and I think it is very dangerous to ignore that future.

Mr. **Chimerine**. I agree with your statement, Mr. Chairman.

The **Chairman**. I will want to go shortly because I want to call on my colleagues now. I would like to get your thinking here as we go along and the rest of the time we have this morning about how we might sit down and talk with ourselves as a country about this. In other words, what is a sensible process, thought as to how we put around the table or in a room some kind of a top level work process to literally wrestle these issues to the ground, decide how we take and decide which changes need to take place most urgently with respect to savings rates and capital investment and educational performance and the others that would be on the list, and how do we go about as a nation talking to ourselves. How do we go about thinking our way through this so that we can map out the choices and the alternatives on the way to agreeing to some kind of a consensus plan?

In other words, if we need an urgent change in national strategy, how do we develop that strategy and who should be represented and by what means do we need that in a nation of 240 million people and a divided government in the sense of State government, local government, Federal Government, public/private sector attitudes, and what have you, huge, sprawling continental nation? How do we take now when we have an urgent need, which you all have said on the record is an urgent need, how do we go about pulling ourselves together as a country to get this thing into focus and then work ourselves through it systematically so that we can come up with this strategy, this in a sense a recovery strategy or surge strategy that gets America back into the ballgame the way we need to be?

And I am going to ask you to reflect on that, but I want to yield first to Senator Wirth and Senator Bryan.

Senator **Wirth**. Thank you very much, Mr. Chairman.

I am going to ask each of you to think about and then respond to a question that has some specifics to it.

If you were sitting down with the President, what would you say to him about, one, what are the four most damaging indicators if we continue on our present course and, second, what are the four steps that he ought to be doing, he ought to be taking right now?

And while you think about that, let me just reflect on two things. One, Mr. Chairman, this has been an absolutely extraordinary trio, and the substance of what they have to say is just superb.

We also have an obligation to do more than just come and listen to these three. We have to figure out how we are going to market what they are saying. I am astonished at the fact that we are at the precipice, the sense of urgency is as real as you and I and our witnesses feel, and yet that is not permeating into the country, to the administration, to the economic press, to the press overall, to the political structure. There is no sense of urgency.

We have sort of fallen away from the feeling that used to be, that, well, we may have a recession or might have a depression where we are going to fall off the edge, and that created the sense of urgency that catalyzed people to action.

From what all of you are saying, we are not going to fall off the edge. We are going to slide down the hill and as you slide down the momentum increases but, you know, there is no kind of a momentary disaster. We have got to somehow figure out how to create the sense of urgency, the precipice. We have to create that precipice ourselves, and we have to figure out how when we have hearings as good as this we do a much better job of marketing that out to—in whatever way is possible, you know, using the media, inviting C-SPAN, really working on it and getting this out, because what these three gentlemen had to say is unbelievably frightening and unbelievably important.

Having said that, giving you time to reflect on your recommendations to the President, I ask each of you, if you might, just to give us what are the four—if we continue on the present course, what four things are going to be most striking about our decline and, second, what are the four most important steps that he ought to be taking.

Mr. Friedman, maybe you could just pop right through this, and that will take up my time, Mr. Chairman.

Mr. **FRIEDMAN**. I suggest four indicators, Senator.

First, our Nation's investment rate. How much are we investing compared to our income?

Second, how fast is our productivity growing?

Third, how fast are real wages moving and, indeed, in which direction are they going? Is it up or down?

And, fourth, our net foreign debt, again taken as a ratio to our gross national product.

These four are obviously interrelated, but they tell different aspects of what is in fact the same story. All four tell a very sad story right now.

In terms of four steps that the President might be urged to take, I think the first is to show some leadership on the budget problem. Having spent a fair amount of time in the last year talking to Members of the Congress, on both sides of the political aisle, I have become persuaded that the principal missing ingredient to addressing our budget problem is Presidential leadership. If the President were to construct a package that would represent genuine deficit reduction, including spending cuts across a broad range of programs and also some revenue increase, I am persuaded that that would be met with approval from both political parties in Congress and, indeed, approved in the country as a whole. Instead, however, I see Mr. Bush leading very strongly in exactly the wrong direction, persuading the country that nothing needs to be done and therefore nothing will be done.

Second, I think the Government needs to, and can within the appropriate budget guidelines, promote civilian research and development. Not all of our productivity program is simply a matter of how much investment we do and therefore a matter of the budget. There is also the key question of research and development. Our R&D spending shrank in the 1970's. In the 1980's we have had a revival, but only in military-related R&D. I believe that we also need to have a revival of R&D in industries that are directed toward civilian production.

Third, I believe we need to reform our education system in the United States. Here, however, I am not convinced that the Federal Government has a leadership role to play. But to the extent that the Federal Government can play a constructive role in that process, I think that would be all to the good. I intentionally use the word "reform" because I do not think that what is now wrong with our education structure in the United States is simply a matter of not enough dollars put into enough schools.

Finally, in conjunction with these other steps, but only in conjunction with them, we also need to press ahead in the trade policy area to get Japan and other countries to relax restrictions. Last week I was in Japan, talking with leaders at the Ministry of Finance and at other government agencies. As long as we not only fail to solve the problems that are so clearly on our side to be solved, but show not the slightest interest in even addressing them honestly, the Japanese can and will not take it seriously when we address the problems that need to be solved on their side. The Japanese know that they have problems to be solved, and so do we. For us to allow the Congress of the United States to become a joke by continuing to pretend that we are solving the budget problem, living within Gramm-Rudman or whatever is the current mythical guideline, while everybody knows that that bears no relation to reality, is highly counterproductive in just this context.

Senator **Wirth**. Mr. Chairman, I know my time has expired.

The **Chairman**. Let's go right on down. Let's get the answers.

Mr. Burstein.

Mr. **Burstein**. Thank you.

I appreciate Senator Wirth's request for four indicators and four ideas. Usually, I get a request for one idea, and just the mere request for a list of four suggests a new level of complexity to this discussion. Although I would caution that four is too small a number, I will do my best.

Senator **Wirth**. In 10 minutes what can you do?

Mr. **Friedman**. Senator Wirth was very well educated, and therefore is able to tolerate complexity.

Mr. **Burstein**. Speaking of the indicators, I laid stress in my comments and in the material I have submitted for the record on this capital spending difference. But it is a statistic. It is a number. People don't realize what that means.

I would suggest that if people went and looked at what is happening in Japanese factories and in German factories and came home and looked at what is happening in American factories, they would have a very different perception of this issue.

If you look at things like the so-called "robot population", then you see that in Japanese industry they are using today perhaps 20 times as many robots as we are using in American productive mechanisms.

If you look at the computer chip industry where our level of rejected material is so high that it drives up our costs and makes the Japanese and the Koreans so much more competitive—and then you go and you look at how much the Japanese and the Koreans are investing in the next generation of computer chip production technology versus the situation here, you get quite frightened about these things.

I would suggest that this difference should not be treated as an abstraction. The fact that the Japanese are investing right now today on a GNP basis 2.4 times as much as we are in capital expansion is a very, very dangerous indicator.

Part of that also means that the areas of excellence we still cling to in this country are rapidly eroding. There was a lot of reportage this year of the Tokyo auto show. Now, everybody knows the Japanese are very competitive in the automobile field. But it has been thought even in the recent years of the onslaught of Japanese competition that when it comes right down to basic design, taste, if you will, American and European auto manufacturers still lead the world. Well, the reportage of the Tokyo auto show this year was that everybody who went to it said, "oh, my god, the Japanese are moving into every area of leadership where we have still had some influence in the auto industry.

And I would also note there that in these industries that we treat as fads—high definition television, superconductivity, biotechnology—where we get interested for a while, invest some money, have some discussions in Washington, et cetera, the Japanese are working on all these industries in a very concentrated way.

Second, I would look at what is happening in the world—at the enormous change, politically and economically, that we are living through, particularly these fascinating developments and welcomed developments in Eastern Europe and the Soviet Union, the creation of a truly global economy, the creation of a truly global financial system, et cetera. I would look at what is America's role in this. I mean, after having fought 40 years to bring about these changes, after having fought 40 years to have a unified and prosperous Europe, after having fought 40 years to create a free trading system, after having fought 40 years to create a global marketplace, who is getting the benefit out of these things today as these processes unfold?

And I would suggest if you look carefully at that you will see that the Japanese, the Europeans, particularly the West Germans, and other emerging Asian economies are benefitting in a very disproportionate way from these changes in the world, and we are faced with a situation where we are partially unable to adapt to these changes and partially unwilling because we don't have the resources.

American companies are not about to rush into the evolving Eastern European marketplace and invest huge amounts of money when they are having difficulty investing money at home. I suspect that the Germans and other Europeans will benefit from that development greatly.

I would look at the pattern of foreign acquisitions in this country, and while I am not against foreign investment in the United States at all and I think it goes with the territory of a global economy, I would look at the patterns. I would look at the degree of the auto industry, which is becoming dominated by Japanese manufacturers in this country. I would ask why is it that the most modern automobile factories in the United States have all been built in recent years by Japanese companies in the United States and why are the big three auto makers all producing cars in Japanese-owned factories in the United States under American labels?

I would look at the banking industry, and I know you did this in your recent hearings, and look at what it means if 25 percent of commercial lending in the mid-1990's is being done by Japanese banks in the United States as it is being done in California today.

And finally——

The **Chairman**. Can I just underscore that for a minute?

Mr. **Burstein**. Yes.

The **Chairman**. That is a very important fact and it sort of goes by in a hurry. When you go back and look at the import invasion on cars and trucks, the Japanese, following an intelligent strategy for them, came in from the two coasts. So I think you are probably seeing in California now, you know, what will become a nationwide condition, and if banking is now—Japanese banking is now 20 percent of the activity in California, which you have just said, I think that is the first wave of a breaking wave that will move across this country over time.

Is that a——

Mr. **Burstein**. Yes. One of the reasons the Japanese presence has been so concentrated in California is that it was created in a time when that was the most attractive market and banks basically had to choose one state to operate in. As they get the freedom to expand from that base through further deregulation of interstate banking and other regulated matters we will see them expanding throughout the country and throughout the system.

Turning back to the more proactive and prescriptive part of Senator Wirth's question, I want to lay stress on the first issue, being the moral question, the question of leadership. A government, a Congress, a President must be able to focus attention and to set an agenda. I don't think we are doing that now and I think that has to be the first step.

I looked at the San Francisco earthquake coverage, and I was amazed at another vision of when Americans are confronted with a crisis people get out and do all kinds of stuff in a very inspiring way. It is not like we don't know how to solve problems in this country. It is not like we don't know how to get into urgent action and do things to help our community and our fellow man. It is a very basic American instinct.

The problem is that instinct is not being called forth today. It is not being given a pulpit. It is not being given a direction.

I have argued and I have gone to some length in the paper I submitted that the key issue here is to focus American attention on the long term. All these issues we are discussing today don't look threatening in the immediate sense. All of them, if you judge only by short-term interest, have a different set of solutions than if you judge by long-term interest. The solutions you adopt to address the short term are the ones that kill us in the long term.

We need leadership out there that is willing to take the heat and say we have got to make some sacrifices, we have got to make some cuts, we have got to focus on the long term and the country is going to be better off for it. I believe people will respond to that.

Within the other prescriptive steps of most urgent importance, I would call for a package of steps designed to reduce the cost of capital and to make capital investment easier. That would certainly include massive trimming of the Federal deficit. It would include incentives for savings. It would include other measures that many brilliant economists have put on the table and I don't think are difficult to adopt.

I favor what I call a post-industrial policy, where Government plays an agenda-setting role in certain aspects of the private sector, looking at industries of the future, looking at the large-scale employment patterns of the future, looking at the trade patterns of the future.

I hear all this talk about how Government is notoriously bad at picking winners. I don't know that we have had much experience in this country. I have a hard time justifying that comment. We have not——

The CHAIRMAN. If I may say, we picked the space program. I mean now—and I think it is fair to say if you look at what has been accomplished over several decades it has been a winner.

Mr. BURSTEIN. It certainly has been.

The CHAIRMAN. It has been a winner internationally. It has been a winner internally.

Mr. BURSTEIN. And we believed during that whole period of the 1960's, when I was growing up as a kid and watching Alan Shepard and John Glenn and all those guys on TV and the whole nation was riveted on this great challenge, we believed, we were told, and it was true that the R&D that was going into those products was washing into the consumer sector. I think that program was enormously successful in that regard.

Senator WIRTH. We have picked the State land grant university program. We have picked the National Defense Education Act. We have picked vocational education in the 1920's and 1930's, and we picked the interstate highway program. We have had one example after another of picking winners and losers, and we have done it in a deliberate way in a political society and been enormously successful.

The CHAIRMAN. Public power projects. I mean, you know, there is any great number.

Mr. BURSTEIN. I agree with you.

The CHAIRMAN. The Manhattan Project.

Mr. **Burstein**. The issue is to find ways to avoid narrow political and pork barrel interests, but I think we can find bodies of people who can make those decisions in a way that is above those considerations. I think this is crucial.

Within that post-industrial policy, a component of it, as I see it, is a more active and intelligent trade policy. I agree with Ben Friedman that the Japanese are not going to do much until they see us do more, but even if we do more I am not sure they are going to do much, and I think we need to have other methods of dealing with that relationship. I could go into depth on that, but I think most of you probably have the sense that we don't have much of a trade policy today. In the same way that we need to be able to pick winners in the private sector and support those efforts, not necessarily with large amounts of money, we need to be able to pick trade goals that really make sense and that will really change things if achieved and fight consistently for them.

Finally, on the education issue, you know, this is the buzz word of the 1990's. Everybody is aware of how bad the situation is. Everybody is aware we are going into the information age, that we are already living in it. Everybody is aware that education is crucial to competitiveness in the future.

But I don't see the focus on action. I think it does have to come at a national level. It can be reinforced at the local level, but I think it has to be more than the schools as such. It has to include specific incentives to get the best and the brightest into engineering and into industry and not into law and investment banking and politics, and that is part of the educational issue.

We must turn out literate kids from the high schools. There is no doubt about that. And we have to be training people in a broad variety of skills. But if you look particularly at Japan and Germany's success, one thing I would really stress is their ability to train large cadres of people who are engineers, who have the skills to go into the workplace and advance the cause of productivity and technology and its introduction into the workplace. That has got to be a key component of any educational effort.

I hope that——

The **Chairman**. If I can insert something—we want Mr. Chimerine's answers to those two questions as well, and we will go to Senator Bryan—I just want to insert for the record a little bit of data on the educational gap, United States and Japan.

Our high school dropout rate nationally is about 26 percent. Theirs is running at about 2 percent. You talk about a defect rate or a failure rate in any system, let alone our educational system, it really takes your breath away.

The data that I have shows that the average student in Japan goes to school 240 days a year. Our children go 180 days a year. All other things being equal, that is a huge difference that would seem to add to their advantage. Average hours of homework per day in Japan, 2 hours a day; in the United States, ½ an hour a day.

With respect to the years of math required at the high school level, 3 years required of math in Japan, 1 year in the United States. Foreign language requirement—Japan I am told has a 6-year requirement in foreign language training; ours in the United States ranges from none whatsoever up to a maximum of about 2 years in a very handful of places. And in terms of the percent of college majors in technological fields, which comes right back to your point, it is running at about 5 percent in the United States and about 20 percent in Japan.

So if you just take that one bilateral comparison of the country that really has made the huge differential surge and bring it down into education—there is other educational data we could look at—a very, very powerful gap here that we must find a way to close.

And with that——

Senator **WIRTH**. Mr. Chairman?

The **CHAIRMAN**. Yes.

Senator **WIRTH**. Senator Bryan has a very important meeting at 11:45, and this is going to——

The **CHAIRMAN**. Let's call on him right now.

Senator **WIRTH**. If he could vector in here.

The **CHAIRMAN**. Thank you.

Senator **BRYAN**. Thank you very much, Mr. Chairman. I would only add to what the Chairman and Senator Wirth have said, this has been truly an extraordinary presentation. I wish it were possible, know that it could never be, that every person in America could sit and have the opportunity as we have had to visit with you.

Let me try to bring the focus just a little bit more narrowly into view in a couple of questions, and then, as Senator Wirth has indicated, I have to go to a meeting at 11:45.

The thing that astonishes me, as many of us have tried to carry this message to business organizations at home, whether they be economic development groups, chambers of commerce, local trade associations, not with the depth and the level that you gentlemen have been able to articulate it so beautifully, but essentially the same message, I don't get any sense of response or urgency from those who you would think might understand it and appreciate it more because they are in the business world, they are feeling the full impact of this competition, and I guess my question to you who go out and lecture and make presentations, if my perception from a state basis is accurate nationally, why haven't we been able to get the various industry and trade associations who you would think would be great allies in energizing the public in making this powerful and compelling case that you have made this morning?

Mr. Friedman, maybe we can start with you and have Mr. Burstein and Mr. Chimerine respond, and if I am inaccurate, please tell me that you don't share that perspective. But I don't get the sense when you talk with business groups that they really have——

Mr. **FRIEDMAN**. My perception is exactly the same as yours, Senator, but I don't have the same sense of surprise about what I see. I get to meet with a fair number of business groups and also trade associations. I think their objectives are typically much more narrow than what we are talking about here. They typically have a quite specific and, as all three of us have emphasized, quite short-run set of objectives to promote.

What we are talking about here is the promotion of the national interest. One should not expect business or trade associations to have as their highest priority promoting the national interest. That is not what they are there for. I think that is what you gentlemen are here for, and that is what all of us as citizens have in mind, but that is not what business/trade groups are for.

Some people say the world has changed. I think so too. But usually people who say that mean something to the effect that we can now get by without productivity growth or investment, or that we don't need this or that any longer. I don't think that is the sense in which the world has changed. The change that is important to me is that our national leaders are presiding, contentedly and complacently, and sometimes it appears even smugly, over the decline of America as a nation.

This is a great change from what we saw in the past—the sense that what we were all about was building a nation, the sense that America was a place that focused on forward progress, which, after all, was the distinctive feature of our society when de Toqueville talked about what made America different 150 years ago.

All that seems to have vanished. As long as we are content merely to look at how well we are doing today, without note that it is all financed on the basis of borrowed money, as long as we are content to notice that everybody is still making a living of sorts, without observing that we are inexorably on a trajectory which places us as a second-class country 25 years down the road, I think it is very difficult to arrest this decline.

What our national leaders ought to be doing is focusing the public's attention on what is happening, calling their attention to the fact that we are no longer building a nation but living off the fat of the accumulated land. That is a terrible change in our national approach. To me it is the single most important issue at hand. But the place where it has to be addressed is here, in the Congress. I wouldn't expect business groups or trade associations to work on the problem. The citizenry as a whole is you must take these concerns.

Senator **Bryan**. Mr. Burstein, any comments?

Mr. **Burstein**. First of all, to pick up where Mr. Friedman left off, there is in America a great national denial syndrome, denial in the Freudian sense, where the very problems that are most important to us and should be uppermost in our consciousness somehow mentally are filtered and denied, even turned into their opposite. If you really look at American politics and this issue of leadership that Mr. Friedman has referred to, why is American politics today focused on issues like abortion and flag burning and the private and personal lives of some of our legislators and leaders?

These are clearly not the cutting edge issues we face, and somehow or other we have created a mechanism that is putting these issues on the table. I think it is a deliberate method to avoid grappling with much more serious issues.

On the other hand, in the American business community today I find in the course of my work, interviewing business leaders and talking with them, there are quite a few people who would agree with large parts of what has been said here today. These are CEO's of major corporations—I might mention Jimmy Robinson from American Express, Bob Allen from AT&T, Bob Crandall from American Airlines. John Young was mentioned earlier. Galvin at Motorola. These people I think are quite keenly aware of the problems and in some cases their corporations are taking some steps on education and competitiveness.

But I think it is wrong to expect that they can lead. In the 1980's and 1990's the American business community has a new influence that it never had quite before, but it has no mechanism to lead. Even so, I think there are some allies there in this issue.

The man in the street I find is actually far ahead of us in thinking about some of these questions. You look at those opinion polls that say that the majority of Americans believe that Japanese economic competition is more dangerous to the United States than the Soviets' military aggression. A majority of Americans say they think foreign investment is a bad thing.

Now, why do we have this dichotomy? We have a majority of American businessmen as eager as possible to sell their companies to foreign investors, and the man in the street is saying we don't think it is good for our long-term interests.

Again, I think we have an ally in the man in the street, in the ordinary person, in the voter, but his thinking is often shaped by racism, xenophobia, fear. He is seeing the decline of America, intuiting it, feeling it in his gut, and somehow expressing that as an anti-foreign sentiment, and it needs leadership to say, yes, you are right, something is wrong with this country, but let's not focus on keeping foreign investment out, let's focus on redressing the imbalances.

There is so much concern, on the sale of American companies to foreigners. I wonder what would happen if the President were to call in some business leaders and say, you know, hey, this company is on the block, they have got to sell the company for some reason, they can't make their interest payments on their junk bonds, can't we find anyone in the American corporate community willing to buy this company, does it have to be sold to foreign interests? Not to legislate. I mean, I think that is the wrong way to do this, but to exercise leadership.

The last thing I would say is I think it is important to realize that the world is facing new complexities, and I give perhaps the larger measure of truth to those who are on the other side of this argument from me than perhaps they would give in return to me, but there are some fundamentally new factors going on and I think the picture is not 100 percent bleak in this country.

When I go to the shopping mall in Danbury, Connecticut near where I live, it is packed with cars, every weekend. You can't find a place to park, the stores are packed with people. This is one big reason why some people don't feel much of a sense of urgency or challenge, and I think that has to do with the reality that in America a large number of people are living extremely well. In fact more people are living extremely well in this country than have ever lived extremely well in any society heretofore known to man. They are a very powerful group of people, and when you look at that side of the reality and not what is happening to the underclass and not what is happening to the factory worker whose wages have declined in real terms, you get a very different perception, and that needs to be factored into the mix.

Mr. CHIMERINE. Senator, let me try to respond very briefly.

I think there are two or three problems that you have to deal with.

First, historically this has been a crisis-oriented society. We generally don't get our act together unless something forces us to do it, particularly when conditions are reasonably sanguine as they are right now.

Second, to be honest, there have been many of us who have been talking about these things for several years now, and in fact some have made warnings on a regular basis that we are headed for calamity, or are headed for disaster. It has never happened, and as a result—there is a credibility problem here, made worse by the fact that whatever erosion we are experiencing is happening so gradually you don't notice it much in the short term.

Five or 10 years from now we may wake up and realize, we have just had ten years of stagnation and things are really not good, and then maybe we will do something about it, but when the erosion is happening as gradually as it is, it just doesn't get noticed quickly enough, and as a result I don't think you get the kind of response that you would like.

The third point is the one that Ben Friedman made. Trade associations and others are interested in their own short-term wellbeing, and if they are suffering from a competitive problem, they are more likely to come to you for import quotas or other kinds of short-term relief measures rather than support the kinds of things that will make this economy more healthy on a long-term basis.

And the last point, reinforcing what Mr. Burstein said a moment ago, the one encouraging thing is that an increasing number of knowledgeable, caring people in this country, people who really understand what is going on and care about the future of this country, Republicans and Democrats, are finally beginning to realize there is really a problem here and are beginning to talk about it. I think you will see that increase in the next several years, and I think that is very encouraging.

Senator **Bryan**. I thank you for ending on an optimistic note. I wish I could stay a bit longer and participate in additional dialogue.

I compliment you, Mr. Chairman, for arranging this outstanding panel, and I thoroughly have enjoyed.

Thank you very much, gentlemen.

The **Chairman**. Thank you, Senator Bryan.

Mr. Chimerine, why don't we come back and let you answer Senator Wirth's question?

Mr. **Chimerine**. I will try to do it briefly, but before I do, just let me make one comment on your statistics, Mr. Chairman.

You cited a number of statistics which indicate that the quality of education in this country is eroding relative to our competitors, and at the same time we spend more on education relative to our GNP than most of the other countries you mentioned.

So part of the productivity problem we have in this country is right within the educational system.

The **Chairman**. Yes, and you remind me of something else. Someone—one of you earlier made the point about health care costs.

Mr. **Chimerine**. Same thing.

The CHAIRMAN. And there we have that same anomaly where we actually pay more and appear to get less, and so when you look at that as a cost of production, which is now a very severe item, it is—just to digress for one second, the Chrysler Motor Company have come in and indicated that their per car cost premium for just health insurance that has to be assigned directly to each unit of production is now about $500 between United States production and Canadian production.

So if you are sitting in Michigan, as I am and where Chrysler is headquartered, and they have got manufacturing plants in Detroit, or in the Detroit area, and right across the river in Windsor they can also produce that same unit of production in a Canadian Chrysler plant and if they have anything like a $500 per car health cost differential that that, absent any other factor, is an enormous item pulling that production out of the country and over the Detroit River and into Windsor and into a Canadian plant.

And of course, one of the interesting things that has come up, I mean the question of why isn't American industry in here beating the door down to say, look, you know we have got a huge problem, let's do something about it, the one area where we are beginning to see some of that is with respect to health care.

This health care differential is now coming in so hard on companies in the auto industry and beyond, who have broad-scale health care coverage, and as those rates have gone through the roof and make their way into product costs they are now—all the alarm bells are going off, and so they are now coming to us just in the last few weeks and months saying, look, we need to take a brand new look at the health care system because it is beginning to eat us alive in terms of product cost in this new global marketplace.

This is the first real tangible sign that I have seen where, you know, something is beginning to happen, and I gather that corporate leaders are even going to the White House finally on this issue and saying, hey, you know, we are ringing the alarm bells because we are being eaten alive by health care costs.

So this may be the beginning of at least a focusing of a part of this much larger problem that you have all laid out, but I just wanted to make that interjection there.

Mr. CHIMERINE. Can I go now, Mr. Chairman?

The CHAIRMAN. Please.

Mr. CHIMERINE. I think your comments about health care costs and education just reinforce a comment that I think all of us made earlier, that this issue of competitiveness is very complicated and it is really multi-dimensional because all of these factors play a role. And in the two cases you cited about education and health care, what we are doing is educating and providing health care to a smaller percentage of the population than our foreign competitors do, and we provide less quality to those that we educate and provide health care to, yet we spend much more than they do, and that is a pretty dramatic, comparison, I think.

Let me get back to Tim's question and first start with four—rather than indicators—ramifications.

If I was talking with the President, I would tell him that if we don't get our act together in this country—and I will give you my prescriptions in a moment—that the four most visible ramifications of current underlying trends as we move through the 1990's would be:

First, probably a prolonged period of slow economic growth in this country, a process which I think is already beginning.

Second, stagnant living standards. As we have all said, it will be very difficult, if not impossible for the next generation to do better than we are doing, which breaks a tradition we have had in this country for a long time.

Third, we won't have the resources to address some major problems in this country, whether it be drug abuse, finding a cure for AIDS, fixing some of the bridges that are falling down on the highways, and other things.

And, finally, we are going to see increasing foreign ownership at a rapid rate.

And if we don't change the underlying trends currently in place, in my judgment, those are the four most significant consequences we are going to see in the 1990's.

What can we do about it? What would I tell the President if I had the opportunity?

First, I think I have got to tell him that instead of going up there and telling us that everything is terrific, he has got to tell it like it is, that we have had a wonderful recovery for the last 6 or 7 years, but that the underlying factors that will determine our economic performance in the future, let's say for the next 10 or 20 years, are not favorable. If anything, they have become less favorable during the last few years, and that if we want to continue the prosperity in the United States, we have to make some fundamental changes. Unfortunately, I don't see this administration willing to make that claim, but that is number one on my list.

Second, I think the President would have to admit that if we are going to change the underlying trends we need a Government-led focus. It is unrealistic to expect all of these problems to be addressed in the private sector alone, and the Government is going to have to play a major role in the process.

The first action that I recommend as part of this process is to set goals for the economy. I think the President ought to tell us that our major national economic priority is to restore the 3 percent trend in productivity growth we had in the 1950's and 1960's, which means a tripling of what it has been in the last 15 years.

Second, he ought to be laying out goals as to what as a country we have to do to reach that objective. We need to get, for example, the saving rate up from 5 percent to 8 percent. We need to get the investment rate up from 11 percent to 20 percent. We need to reduce the illiteracy rate from such to such. We need to get average SAT scores up. We need to get the R&D rate up—whatever it is. He should set specific quantitative goals that we are going to strive for in this country in the next 10 years in order to reach our objective of accelerating the underlying trend in productivity.

The CHAIRMAN. That is a terrific idea, by the way.

Mr. CHIMERINE. Third, I think the President has to be willing to use the Presidency as a bully pulpit. If, for example, we see a proliferation of these potentially counter-productive, debt-financed, leveraged buyouts and acquisitions, which are diverting our attention away from real investment, from product development, and from research and development, are making the economy more risky, I think it is appropriate for the President to say, "This is not in the national interest."

We have not had any of that in the last 8 years; quite the opposite, we have had an administration that does not appear to know what really is going on, or does not care much about it. I do not think we can afford that any more in this country.

Senator WIRTH. John Kennedy and Roger Blaugh.

Mr. CHIMERINE. Basically. Not exactly duplicating that, but——

Senator WIRTH. No, but I mean the kind of use of the office.

Mr. CHIMERINE. Yes. I think what happens in this country is the responsibility of the President, and when things are happening that are not in the national interest I think his job is to make that known to the public.

The CHAIRMAN. Yes. If there is one person that presumably can speak with one voice, that is the person.

Mr. CHIMERINE. Yes.

The CHAIRMAN. I mean, that is the only person that we elect at the top who is elected by everybody.

Mr. CHIMERINE. That is his job. You cannot do it. 530 Congressmen, and Senators cannot really play that role.

Then, there is the last of the four government actions, and that gets to the whole issue of fiscal policy. I think the problem is, if anything, more complicated than most people realize, because of the focus on the budget deficit.

There is no question, at least in my view, that we have got to get the budget deficit down, and that when you really measure it properly, if anything it has not improved at all. It is outrageously high for this point in the recovery process.

But it is not just the size of the deficit, in my view; it is the priorities embodied within the deficit. Because I think whatever spending cuts we are making probably are in the wrong areas. We are continuing to push up the entitlement programs and the current consumption-oriented programs, and scaling back the kinds of things that will enable us to invest for the future.

It is incredible how small a percentage of Federal spending by and large is building for our future. Almost all of it is going to finance current debt, to provide social security benefits and health care benefits to the elderly, to pay for defense or whatever, and very little of it is being spent on preparing and building for our future.

I think what the President's fourth priority should be, after the first three I have outlined, is to put a realistic fiscal program in place that, number one, reduces the deficit on a meaningful basis, without the use of gimmicks such as we have been doing in the last few years; while at the same time, shifts our priorities in order to help the Government play the role it should be playing in meeting those quantitative goals I talked about earlier.

For example, we have to get R&D up, if that is one of our objectives, what government programs need to be increasingly funded in order to help achieve that objective? If we want to improve retraining of workers, what government programs need to be increased to do that? If we want to get SAT scores up, or get the illiteracy rate down or whatever, how much more do we need to spend on education?

So I guess the fourth thing essentially is a complete new approach to fiscal policy, which simultaneously addresses our priorities as well as the size of the deficit in a way that is consistent with achieving our number one objective: getting productivity growth back up in this country.

And quite frankly, I am sort of pessimistic, as I do not see the administration moving in any four of these areas that I have laid out.

Senator WIRTH. Mr. Chairman, let me just comment.

The CHAIRMAN. Please.

Senator WIRTH. My comment on it and the definition of the problem, I think that was extraordinarily useful in sort of giving us the scope of your best thinking as to what is at the top of the agenda.

On the problem side, I would just suggest two other themes that are coming at us very, very rapidly. One is what I would call our ability to govern in a democratic society. The gap between rich and poor, the hard core of people who cannot participate in our society, reflected in the drug culture, in a lousy education program, in illiteracy, is growing dramatically.

Couple that with the sense of declining expectations, the sense for the future that your children are not going to be able to get the kind of education better than you did, or have a house that they can graduate into from where they grew up—those kinds of expectations, coupled with that gap between rich and poor, it seems to me has within it the makings of some very, very dangerous social dynamite and some extremely important implications for our ability to govern with the kind of spirit of generosity that our democracy has had for 200 years.

I think that—I do not know what that is, but I think that that is coming at us more rapidly than we imagine.

The other item that I think is coming at us very rapidly, and that goes to your point about not having resources to put in other areas, is the environmental crisis, which is rolling in on us so quickly, and we do not see it as much in the United States, but it is elsewhere around the world. The global commons are being desperately damaged, and that is going to come back and hurt us in ways that we will not be able to do anything about. We have got to move on that, as well.

We have no capability now of doing that. We have no resources for doing that. We are spending $300 billion on defense, and $6 billion on the environment—$5 billion on the environment. You cannot tell me that the defense threat is 60 times greater than the environmental threat. I mean, that is just preposterous, in terms of those very priorities that you are talking about, Larry.

Anyway, enough from me. I mean, that is more than my share, Mr. Chairman. I want to thank this panel. I think it is absolutely wonderful. And again, when we have these kinds of resources available, we have got to figure out how we get the quality and the depth and the urgency out to as many people as possible.

We do not have much of a bully pulpit, but what we have to do is that we have got to get up and yell and scream and try to use the microphone every chance we get.

Thank you all very much. Thank you, Mr. Chairman.

Mr. CHIMERINE. Can I make one quick additional comment? And this is directed I think not only at the administration, but at the Congress.

The thing that distresses me the most is that we are not even debating some of this. I mean, as Dan said a minute ago, we are spending our time now passing legislation on flag burning, and in the last campaign on who polluted Boston Harbor, and these kinds of things, and the major issues are not being debated.

One of the things I would like to see take place in this country is a debate on the 10 key factors, or however many we identify, that we think are necessary to address in order to improve productivity.

We've mentioned most of these this morning, Mr. Chairman; the cost of health care, the cost of education and the quality of education, getting R&D back up, higher investment, whatever. I would like to see a national debate at least get started on what are the most effective ways to achieve each of these goals, which ultimately will lead to our primary objective, of improving our productivity and improving our competitiveness.

The CHAIRMAN. Right.

Mr. CHIMERINE. I do not know the answers. Personally, I do not know what is the best way is to improve our education system. Somebody must know, though. We do not seem, at a national level, even to be debating and discussing this.

The CHAIRMAN. Yes. Yes. Let me give you a sense as to where I think we are going here. This committee, we have had a change of course this year, in terms of my assumption of the chairmanship. We have had some change in the membership of the committee. So in effect, you have got a recast Senate Banking Committee.

In terms of the operational definitions of which committees in the Senate get what operational authority, it turns out that this committee has a very explicit authority to look precisely at these questions: the financial and economic health of the country, where are we, and where are we going? What do the trend lines tell us?

It has been in large measure an unused authority in recent years. I do not say that to cast an aspersion on anybody else; it just is what the record shows. It is interesting, we have oversight of the Federal Reserve System and a whole host of things that obviously lace right into this question of monitoring and trying to determine where we are going, how we are putting our overall economic and financial policies together, and importantly, what are the bottom line effects. In other words, how are we doing? Are we getting stronger, weaker? Are there big economic defects materializing in the economy, and so forth?

This is my principal interest in national policy terms. I mean, this is an issue that I think about and work on more than I do any other, and I need to spend even more time. But part of that is the problem of hours in the day.

This committee this year started out with an emergency problem on its doorstep; namely, the savings and loan catastrophe. And so we spent a very large part of this year having to work through that, and enacting that financial recovery plan and reform plan for the savings and loan industry.

That has now been done, and of course there are a lot of oversight responsibilities now and implementation responsibilities that are a follow-on to that, so that work in effect has not ended. It has changed, but it still requires a fair amount of work by the committee and by the members of the committee.

In addition to that, there is a host of other issues that are on the table: Securities laws issues that go to some of the things that have been touched on today; we have got some HUD issues and problems, both problems in the past and the question of how the programs get redefined in the future. And I will not go down through the rest of the laundry list.

But I tell you this, because you now are as invested in this process as anybody, because you have taken the time to come and you have prepared and so forth, and I want you to get an idea of where we are going.

We are, with the other hearings that have been cited, with Bobby Inman, with Carlucci and others, we are laying a very systematic foundation of information from the top experts that we can find in the country, which you today constitute in terms of the importance of this panel.

The Nobel prize winning economists who will be with us tomorrow represent another very important aspect of this task of putting this picture together and getting it up on the radar screen, and bringing it to the attention of the country.

I just must tell you, I am absolutely determined to get that job done, and we will get it done, with or without the help of others and other branches of government.

Now, I do not say that in a combative way. I want the other branches of Government involved. I have talked to the President about this, and I have talked to others in the administration about this, precisely to try to help create a higher sense of urgency about the need to get moving on these things. We will continue to do that.

I know that Tim Wirth feels exactly the same way, as do many other members of this committee, some of whom have been here, others of whom were unable to come this morning.

So my own view is that facts are important. There are a lot of times when facts should be important, and they do not get the importance that they need to have. You have put a lot of factual information on the table today. It is profoundly important, and it is not going to get lost in the shuffle. That is my pledge to you, in terms of what I intend to do with it in conjunction with my colleagues and the work that goes on here.

Some of us who have been around for a long time have been in on the early going of the work to solve some big problems in the past. Vietnam in the early days was not an easy problem to figure out, and there was an enormous, I think, misconception in the country about what it was, and what we were doing, and where we were going, and so forth. And it took quite a long period of time for America to get its bearings and to decide that that was really a mistaken venture, and to work our way out of the situation.

I do not try to draw here any one-for-one comparisons, but only to say that there are other illustrations in contemporary history where it has taken the United States a while to shake itself of some faulty notions and some hubris and some historical references that are not relevant to the current situation, and to finally work its way to a strategy, a forward strategy, that made sense.

That is precisely what has to happen here. I mean, the post-war era that we have lived through since the end of the War is gone. I mean, that has been transformed, and we are now into an entirely different situation that requires different strategies, different insights, and a radically different overall economic strategy.

We have to now not only bring ourselves through this educational process, to understand what reality is and what the future reality is that is coming at us; but we now have to engineer what I would call a surge strategy, that really takes and dramatically lifts the performance of the United States.

I like the goal-setting idea. I think that is precisely right. It would be much preferable if the President would do this; but it has to be done, whether he is the person who does it, or you do it, or we do it here, or whatever.

I can assure you of this. We will do it here. We will, with your help and the help of others, try to identify what constitutes a sensible and rational goal structure, in terms of, how do we set the targets for this surge that we now must engineer for ourselves, and then how do we make it happen?

I think, even in the area of public feeling about it— you know, I have been using a phrase, and it is a very simple phrase but it is a very important one, and the way I feel and view this thing. That is sort of a "Team America" concept.

In this world economy that is now out there, if the United States cannot think and work as a team, we are in real trouble. If we are going to dissipate a lot of our time and energy with endless quarrels internally, and endless frictions, and endless head-knocking among ourselves, and we cannot ever sort out and agree on a competent and effective international strategy, then we are going to keep sliding backwards, and we are going to lose influence, and we are going to have a miserable future, a miserable future.

I do not say tomorrow morning, or in two years, but just extend these trend lines indefinitely, and we are bringing into the lives of our children consequences that I think really would be unforgivable, if we do not do something right now to prevent them.

Now, I had to step out of the room for a minute, but Tim was talking about just the question of the social stresses that are building up, and the problems of the underclass. When the murder rate in this town is running more than one a day—and I cannot from memory give the comparisons, but I don't know, there is a handful of people murdered every day in Japan for example, or most other modern nations—we are going to have over 365 people shot and killed, just in terms of gunshot wound deaths here in this town, the capital city of the United States of America, this year. And that is not atypical. That is what we are seeing all around the place.

We are seeing the signs, because of the drug war and a lot of other manifestations, of a kind of incipient break-down of part of the social order that logic would tell you would start to accompany a kind of relative decline in national performance. In other words, these things are interactive over time.

You can create a situation where you start to develop within your own society—and I have sort of mixed feelings about using this phrase that I want to use, because it could be sensationalized out of proportion to how I mean it, and I want to sort of file that caveat—but you can start to get some elements of a kind of "Clockwork Orange" end-game developing in your society, that any rational person would say to themselves that these are the manifestations of things going wrong.

Whether it is homeless people—not enough hot air grates in Washington to go around in the winter time when homeless people are trying to keep from freezing to death. We now have so many in Washington, we do not have enough hot air grates, literally, and we have a lot of them, where they keep warm in the winter to keep from freezing.

Whether you take that, take the high school drop-out rates, the murder rates off the drug problem, or many, many other elements of a kind of deterioration at least in major parts of the society, you have to say to yourself, "How do I relate this to this growing relative under-performance in the international economy?"

I would just add one other thought to it. Something that one or more of you said really struck me in my mind earlier. Yes, we have had this recovery for the last decade, recovery as it is. There are elements to it, and there are a lot of missing elements to it when you really take a hard look and put it under the microscope as to what kind of recovery it has been.

But what is indisputable is that the recovery that we have had, albeit with the caveats, the cost of it has been put on a credit card. We did not pay for the recovery; we decided to borrow, and in a sense put the recovery that we have had on a credit card. Somebody in the future—namely, our children and ourselves and others—is going to be asked to pay for the recovery that we have had that we decided we could not and would not pay for.

So you have built into this that kind of dereliction of responsibility as well, in that in a sense what we have done and what we have had in a sense is sort of a picture that looks better on the surface than it really is underneath. But even that was not something that we were willing in any honest and straightforward way to pay for. We put it on a credit card, the same way that you might go and check into a fancy hotel somewhere and not pay your bills, live there for a long period of time, eat in fine restaurants and so forth, but just run a tab down at the desk, and hope that some day in the future, you know, somebody else would pay for it, or they would not catch you and make you pay for it, and so forth.

That is the nature of the dilemma. I mean, I think that the discussion today has probably put the dilemma facing the country in as clear a focus as it has been put in anywhere where I have been privileged to be. And as I said earlier, I have had the chance, as had Tim, to hear you speak before.

But I will just finish by saying that, with every ounce of strength I have in my body, I am determined to take this kind of insight, and this kind of national imperative, and this kind of urgent requirement for change and for action—I am determined to do everything I can to bring about the steps that are needed.

So I intend to talk about it every chance I get. I intend to lay out plans within this committee. I intend to continue to lobby everybody I can get my hands on in the administration. I intend to talk to every business leader I can, every citizen group, in every way that I possibly can myself.

So that is in the nature of saying to you that today is a serious, a very serious meeting, for a serious purpose. There will be follow-on effort and follow-on. I do not know how long it will take us to finally get everybody awake to what is going on and what has to be done, but that is our mission.

I think we should give each of you the chance to make any closing comment that you might want to make. We have got a whole list of questions for the record, that I am not going to give you now, but will ask you to submit, but which are very important for us to have to fill out this hearing record, some from me, some from other members.

But do any of you have any sort of final closing comments that you want to make?

Mr. CHIMERINE. I will make one, Mr. Chairman, very briefly, because I do not want to hold up the hearings any longer. But I think perhaps the most significant thing you said was your comment a couple of moments ago, which I strongly agree with, that the warning signs are all here.

In the widening distribution of income, in the increasing underclass, in the stagnation of real earnings, the warnings are here. If we do not act, we are going to look back 10 or 15 years from now and ask ourselves, "How did we let this happen?"

That is what is most disturbing, because unless you are a rigid ideologue taking an extreme position, there is just no justification for not accepting the fundamental problems and beginning to look ahead. As I say, the warnings are here, and the evidence is very clear.

Mr. BURSTEIN. I would like to add that I very much appreciate the Chairman's concluding remarks here. It is good to know that some people in this city are facing these problems with the seriousness that I think they require, and I like the action orientation towards coming out with ideas and remedies and plans that you have indicated.

I would like to touch on a couple of points in conclusion. Senator Wirth expanded the discussion, and now Senator Riegle has added to that, by making clear that we are not just talking about events that take place in the financial world, we are not just talking about events that take place in the competition between an American company and a Japanese company; we are not just talking about unemployment of American industrial workers as the worst thing that could happen to us.

We are talking about the collapse of the very fabric of American society: the crime and drug problems, the educational problem, the underclass, AIDS, and the environment, and the lack of ability to come to grips with these problems in the current situation.

I just want to comment on this. I have heard a lot of people challenge some of my viewpoints and say, "What is wrong if America is not number one in the world any more?" Other countries used to be number one, and are not number one any more. You know, some countries are not very important economically—Switzerland, Sweden, Norway, Denmark, Holland—and they all seem to live very happy lives there. So what is the big deal? Why do we have to pitch this as a life-and-death competition?

I think it is very important, as Larry Chimerine has mentioned, to understand that, in our particular American context, which is not necessarily true of other societies, much of our ability to keep the levels of rising expectations and to keep meeting those levels of rising expectations, and to keep one generation living better than the next, and to keep the kind of enormous social progress that we have had through most of the 20th century has directly correlated with our global competitiveness and our global power. Directly correlated.

Other societies have been successful for other reasons, but this has been one of the principal engines of our growth.

As we start to lose that, as we start to lose world markets, as our own market starts to be dominated by other competitors, we lack the resources and the ability to keep having that generously expanding pie.

One of the things we like to say about American history is, you know, we have this sort of classless theme to it and a great record of social progress and so forth. When you start narrowing the pie, this country can become a very ugly and violent, have-and-have-not society. And the domestic implications of that are directly related to the somewhat more refined and rarified issues about capital investment or robots in Japanese factories.

Finally, I believe that you will be successful in your effort to chart a direction, because I believe that the answers are not so hard. It is the irony here that the problems are enormous, and as time goes on with each passing day they get worse, but the answers are not that hard.

Many, many good studies have come out, I think you will hear from your Nobel prize winners tomorrow. There is no mystery about what needs to be done in this country. I think that prescriptive measures suggested by many people whom I respect tremendously are out there on the table. The fact that we could allow the situation to deteriorate, not for want of the answers, but for want of the leadership and the willingness to implement them, I think would be disgraceful.

So I wish you the best of luck in your undertaking, and I do have optimism that you will be successful in it.

The **Chairman**. Thank you.

Mr. Friedman.

Mr. **Friedman**. Mr. Chairman, I also congratulate you again on this initiative, which I think is very important for the country. I was especially pleased to see that you and your colleagues perceive, quite correctly in my view, that what this set of issues is all about is much more than economics, narrowly defined.

On the international scale, we are talking about the ability of the United States to project American democratic values and democratic institutions on the world stage. One does not have to be a pristine defender of every aspect of American foreign policy in the past to believe that, within the last half-century, the world has been a better place for our country projecting our democratic values and institutions.

There is a widespread feeling today that we ought to share some of the responsibilities that we have exercised, solely by ourselves, during much of the post World War II period; I agree. But there is a big difference between sharing number one, and being a second-class country. When the public at large realizes that sharing number one is not what it is all about any more, I think people will become very upset.

Second, at the domestic level, your comments show that you and your colleagues clearly understand that the issues here go to the fundamental essence of what America is all about. We are talking about economics, but it matters because we are also talking about the material basis underlying what we value in our society as we know it. We are talking about what has made possible, over the generations, the openness of opportunity, and the social mobility, and the commitment to democracy itself that we all recognize as the distinguishing features of American society. Nobody has ever suggested that democracy would work in a lifeboat. As we continue to undermine the material basis for our society, we have to realize that the consequences of what we are doing are very, profound.

I was pleased, before I came here, to know that you are taking this initiative. I am even more pleased, as I go away, to understand that you and your colleagues have so full a command, not only of the specific issues, but also of the consequences which in the end are the ones that really matter.

The CHAIRMAN. Let me just say one other thing. I appreciate the closing comments of each of the three of you.

I want to acknowledge the work of the staff members that are present. We have a team here that I think is as good a team as I know of on Capitol Hill, that is working on this issue in a very intense way, and has been for months. Four of them are seated here, and others are seated over here, and some are seated here.

So, we have some I think top-notch professional brain power assigned precisely to try to take and work this through along the lines that we have been discussing today.

I think we have probably said all that we need to say back and forth that way. I want to thank them particularly for the very important work that they have been doing that is critical to our putting this together in a comprehensive fashion so that we can really enable ourselves and the country to talk about these things, understand these things, decide where we are and what we need to do.

You have made an enormous contribution today, and facts have great power. I mean, if we were in the room with no one here but the person taking this down, you would have given us, in an intelligent and compressed fashion, what we need to have to make the next steps on the journey, and I thank you all for that.

Senator Wirth, if you have no further comments, we are going to adjourn the committee with that.

I thank our witnesses again.

The committee stands in recess.

[Whereupon, at 12:30 p.m. the committee hearing was adjourned.]

OVERSIGHT HEARINGS ON THE CONDITION OF U.S. FINANCIAL AND INDUSTRIAL BASE

WEDNESDAY, NOVEMBER 15, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald Riegle (chairman of the committee) presiding.

Present: Senators Riegle, Bryan, Garn, Pressler, Heinz, Dixon, Gramm, and Shelby.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

I must say at the outset that it is a great pleasure to see the faces behind textbooks that I have studied from over the years and I am very grateful to have both of our witnesses today, two very distinguished individuals that I will comment more on in just a minute later.

I want to say as well that we had originally hoped to have Professor Frank O. Modigliani with us and he had planned to be with us today, but unfortunately, he was involved in an automobile accident last week, as some may know, and he suffered some injuries in that accident. Fortunately, he is now on the mend, but we regret his absence, as does he.

In any event, we are very pleased with the two very distinguished witnesses that we have, and we will be introducing them formally just a little bit later.

I want to set the stage for today's hearing by indicating that we began in July of this year to examine the performance of the American economy in great detail to determine whether in relationship to our major international competitors we were losing ground and finding ourselves sliding into difficulty and perhaps on an unprecedented scale in contemporary history.

As I noted yesterday in a very—an excellent hearing that we had here with three other distinguished witnesses, the United States emerged from World War II as the world's preeminent economic power. Our economic might provided the foundation for building the military and political strength needed to stem the tide of totalitarianism that then threatened to engulf Western Europe and Asia.

Fast developing events in the Soviet Union and Eastern Europe and certainly the opening of the Berlin Wall and the growing strength of the economies of free nations suggest that America's containment policy worked and we as Americans should be proud of that achievement, and while I am sure we made our full share of mistakes in policy judgment in the last 45 years, on the whole I think we can be proud as a nation of our world leadership as it has been exercised. For the most part, we have used our economic, political, and military power to create a freer and more prosperous global community of nations.

It is important to note that at the outset, to then say that it all is based on the foundation of our economic strength. That is really what has given us, together with our human values, the basis for our world leadership role.

Over the last several years I and many others have had growing concerns about our country's readiness to be an effective competitor in the new increasingly global marketplace. Obviously, if we cannot compete effectively, our relative economic strength will decline, and so will our ability to be a world leader.

I will not cite a number of the recent statements that we have had here before this committee, but they have come from such important witnesses as people like Frank Carlucci, former Secretary of Defense; John Reid, the head of Citicorp; Gerald Corrigan, the Vice Chairman of the Federal Reserve of New York; people like Bobby Inman, many others that have come before us who have very important vantage points to express a great concern about the erosion of America's relative economic and financial position.

Let me just say one other thing with respect to that. If one looks at the emergence of our debtor nation status and how rapidly that growth in international debt owed by the United States has increased, we are in a position now where our outstanding international debt owed to others is about $650 billion, and it is rising at the rate of $1 billion every 3 days. If one looks at it on a chart, it is a dramatic change in circumstance, particularly for a nation that had not been a debtor nation from 1984, roughly, all the way back to 1914.

So obviously we have had a very dramatic change in circumstance.

So these are very serious issues, and this committee intends to pursue them vigorously, not just through this set of hearings but to bring forward specific proposals.

Today the committee has two of the most outstanding economists in the history of our country, and we are very honored to have them with us today for the discussion.

We have had to start the hearing earlier because we have Lech Walesa appearing before a Special Joint Session of the Congress later in the morning and in order to accommodate that event, which has come along since scheduling this hearing, and this hearing we have had to move our starting time back to 9 o'clock, and I appreciate very much the adjustment in the schedules of our witnesses and just want them to understand exactly what the circumstances are and for the record to note that as well.

Prof. Paul Samuelson, the institute professor emeritus of Economics at MIT, is the man who introduced many college students to the subject of economics through his textbooks on the subject, including this particular former college student and graduate student.

Prof. Lawrence Klein—I should say in addition, of course, as I think is generally well-known, Professor Samuelson was awarded the Nobel Prize for Economics in 1970, certainly as distinguished an award as can be given.

Prof. Lawrence Klein, who is the Benjamin Franklin professor of economics at the University of Pennsylvania, was also awarded the Nobel Prize in 1980 for his outstanding contributions in the field of economics, and as one citizen, I feel deeply indebted to the work and the scholarship that their careers represent and, as I say, I feel very privileged that they are before the committee today and we are most interested in their testimony.

With that, let me yield to Senator Bryan.

Senator **Bryan**. Thank you very much, Mr. Chairman.

I, too, welcome these very distinguished scholars and, as you did, Mr. Chairman, I struggled through with the benefit of Professor Samuelson's texts. It is nice to meet him in person, and I will look forward to hearing his testimony this morning.

The **Chairman**. Very good.

Gentlemen, we are going to begin now and, Mr. Samuelson, we would like to hear from you first, please.

STATEMENT OF PAUL A. SAMUELSON, INSTITUTE PROFESSOR EMERITUS, DEPARTMENT OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MA

Mr. **Samuelson**. I am presenting the title, "America's True Decline, without Exaggeration or False Optimism."

At War's end in 1945, my back-of-the-envelope calculation suggested that the United States at that moment produced almost ½ of total global output, GNP. That was an artificial moment—when Europe and Asia were devastated by the conflict, and our economy was expanded by the fever of the war effort.

After the successful Marshall Plan and MacArthur Occupation, the U.S. share of world output dropped to 40 percent, and during the miraculous 1950's and 1960's in Europe and the Pacific Basin, we saw our fractional share of total world production dropping to 30 percent.

Now, in 1989 I would calculate that our 5 percent of the world population enjoy about 23 percent of total world income. The 1945 to 1989 dynamic change that I have described, I say both as an American patriot and as a citizen of the world, has been a good thing and not a bad thing. It has been in accordance with economic law.

It has been a good thing because the change came not from a failure of our own performance in the 1945–1980 years. Actually, compared to our own history American growth was vigorous in those postwar years, surpassing our rate of progress in the best epochs of our history under undiluted capitalism.

The great change came from the other side, from the remarkable sprint by the Common Market and the Pacific Rim nations—it is interesting, by the way, that the Eastern European socialist economies did not after their quick recovery from the war show a remarkable absolute performance or a remarkable relative performance—but in this sprint these less than most affluent countries of Europe and Asia reduced but did not obliterate our gap of superiority over their technology.

It is hard to be the leader. You have to break the ground. You have to be the bicycle that breaks the wind. It is a little bit easier to be a follower, an imitator, and the wonder is—and nobody understands this—why this catch-up trend didn't happen after World War I in Western Europe.

Well, after World War II they began to do that. Economics, however, is unlike the zero sum game which is power politics. If Bismarck gains, Louis Napoleon loses in the struggle for power. That is not the way it is with economics and economic welfare. When people in India and Taiwan and Spain and London live better and longer, as they have been doing, the enjoyments of my American breakfast, my winter vacations, my standard of living—the average American's standard of living—are not one whit lessened.

Well, historians do not understand economics. They go whole hours trying not to think about the subject. They write in sports page fashion. You know how it reads, but I will give you a capsule sample:

Once Rome ruled the world; then she lost her hegemony. So it was with the Spanish Empire. And, later, with the Dutch supremacy. The glory of Louis XIV's France bit the dust. Britannia ruled the waves and the lands they washed against under Queen-Empress Victoria. That could not last. It did not last.

I am paraphrasing.

So with the American Ascendancy—as cosmic historians fabricate their legends. Our pre-eminence is in permanent decline: as Americans save less, learn less, work more languidly, engage in drugs, and countenance crime and disorder.

Well, as an informed economist, I must correct quantitative distortions. I must paint the picture in its correct shades, neither darkening the bad spots nor white-washing the subtle and insidious degenerations.

The objective picture is one calculated to make us thoughtful in its own right. So let me try to sum up briefly and objectively.

Yes, America is now the largest debtor nation, after being in 1980 the world's largest creditor nation.

I can speak with feeling because I go back almost to that 1914 date when we began to be a creditor nation; when I went to kindergarten and when I went to grade school and when I went to junior high and when I went to high school, we were accumulating a patrimony from net foreign investment abroad.

And not to bore you with the vicissitudes of my life cycle, this was the case well into my grave maturity in 1980, and I think an objective scholar, a well-informed scholar would have expected a continuation of that trend, if perhaps not at the previous rate.

But two unpredicted deficits came along in the Reagan years. First, the chronic budget deficits that go on at American full employment—these are the structural deficits that I am talking about and with respect—in the textbook that you studied and that you studied——

The CHAIRMAN. And he studied.

Mr. SAMUELSON. And you studied.

There wasn't a nice distinction between cyclical deficits and structural deficits. We have something that we call creative obsolescence in the textbook field that requires producing new editions and destroying the used book market; but there are objective economic changes that require revision, and I sometimes think the ideal textbook would be a looseleaf textbook.

Now, that is not perhaps the case in physics and chemistry and some of the hard sciences, but in our subject of economics that is the case.

Well, what I am talking about is a structural full employment deficit. I claim to come into court with clean hands. I have testified before committees like this. I have advised the highest executives of the land, and on many an occasion I have had to be in favor of deficits. But the Keynesian deficits which I advocated, as, for example, when President Kennedy on Inauguration Day took over an economy which was in the 1960–61 recession, were much smaller as a fraction of the GNP than what we are talking about, and they were deficits which were premised upon the high unemployment that prevailed in the recession and which would self-destruct and phase out when we returned to full employment.

Well, the deficits that I am speaking about of the 1980's are something new in American life, and these deficits do—when the national income accountant tallies up the total of the United States thriftiness—do lower America's thriftiness.

What is already our abnormally low private thriftiness as families and corporations, given that we are now an affluent society, given that we are a hedonistic society has superimposed on it this—as the national income accountant cannot help but record—public sector negative saving. Remorselessly, and the measure of a society's total saving is the sum of its corporate net saving, its private family net saving, and its public sector net saving. Therefore our basic deficit is the devil's recipe for a high consuming U.S. economy. Indeed, without our using of foreigners' savings, as the Japanese and Germans and the Dutch have recycled their trade surpluses by capital movement back here, domestic capital formation would be crowded out in our fully employed system.

Future American affluence and political power can be promoted—now I am discussing supply-side economics, genuine supply-side economics—can be promoted only by capital formation in equipment and plant and in human capital training and education; and by investments in pure science, technological know-how, managerial science, and development; and by efficient market mechanisms.

So to speak, our trading partners are now using their trade surplus—which is the other side of the coin, the bad side of the coin of our chronic balance of payments deficit—to plant new capital trees that would otherwise be crowded out and not get planted.

I am speaking figuratively, but you are to think of shopping malls, office buildings, farmlands, branch plants, Radio City, machine tools and inventories financed by junk bonds and equities that foreigners acquire.

When foreigners acquire a share of our public debt to help finance the deficit that I have been speaking of, that share doesn't have to be financed by American savings and capital formation in this country is protected from being crowded out.

So new capital trees that would otherwise be crowded out and not get planted have been made possible by the balance of payments deficit of the United States. The fruits and nuts from those trees of capital will be theirs, not ours, in America's ownership; and it is the trees' fruits and nuts that will provide the source for future dividends and interest that we must send abroad to them.

This is the process we preached about to foreigners in the years from 1914 to 1980, when some people new to economics wondered whether American investment abroad was merely a Yankee trick that was impoverishing people abroad.

Fortunately, no matter who owns the new trees of capital that get planted here, the productivity wages that our citizenry can earn in the 1990's and the new century will be enlarged because these foreign planted capital items were made available for Americans to work with.

Now, to be sure, it would be better if American voters compelled the structural deficit to be reduced toward zero.

To correct the basic budget deficit I am not making an appeal to Senators, to Congress people, to those in the White House. I am assuming that in a democracy the flaw—if there is a basic flaw, a dilemma, or an impasse—is in Main Street and is in the electorate. It would be better if American voters compelled the structural deficit to be reduced toward zero. How can that be done?

Was it your colleague, Senator Aiken, who wanted us to pull out of Vietnam? When he was asked, "But, Senator, how can we get out of Vietnam?" he thought for a moment and said, "I think in ships."

Well, we can do this job by expenditure cuts, all of it by expenditure cuts. Or we can do all of it by tax increases. Or do part by one and part by the other. To a first approximation—speaking not in terms of ethics and human values but in terms of pure economics—it doesn't matter which of those paths is followed.

Either way, we private persons and corporations would have to cut down on our consuming. Either way, the same planting of needed capital trees, now made possible by foreigners' investments, would get done. But this time those trees would be owned by Americans, and their nuts and fruits would accrue as enhanced future U.S. income, while at the same time U.S. workers would still enjoy the enhanced productivity wages in the 1990's and the new century that come from having more and better machines to work with.

Well, let me conclude with some final cautions.

My allies in the crusade to reduce the structural budget deficit sometimes exaggerate.

I haven't read the record of your previous testimony, so I am not in a position to throw a stone at anyone.

Let me conclude by correcting the general record.

A. The inherited deficit, structural deficit—call it the Reagan deficit or the Reagan-O'Neill deficit or the Reagan-Laffer deficit or the Reagan-Bush deficit—that deficit is an evil. But it is not the kind of an evil that entails a nearby recession or a nearby acceleration of inflation.

My next sentence has every letter capitalized, no exclamation points, however; THE CHRONIC DEFICIT IS AN OVER-CONSUMING EVIL WITH INSIDIOUS LONGRUN CONSEQUENCES FOR AMERICAN MIGHT AND AFFLUENCE AND PRODUCTIVITY.

B. America has not been passed by in material affluence by Germany, Switzerland, Scandinavia, or Japan. Actually—and here I rely upon colleagues of Professor Klein at the University of Pennsylvania who over a period of 20 years have been making studies financed by the United Nations and the World Bank to try to get at the true relative per capital real incomes by countries—actually, if we call America's 1989 per capital real income 100, then no nation reaches our level. Closest rivals include—these are my back-of-the-envelope extrapolations of the 1985 and 1987 data—Canada at 93; Norway, with oil, at 92; Switzerland at 88, still only of ⅞ our level of living; West Germany, whom we profess to admire so much—and we should—is at 84; Sweden at 79; Japan, although their workers, I understand, are each 9 feet tall and ours are only 5 feet 5, Japan, if you make the calculation correctly, is now at only 78 to our 100.

Now, if you invite me back in 1999, some of these gaps might be reduced, wiped out, or even reversed in sign. I don't think Japan is likely to be the first in time to catch and pass us by.

C. America is now a net debtor nation. That means we own less abroad than foreigners own here. We owe more abroad than foreigners owe to us now. We are the greatest debtor nation in absolute, quantitative terms. But unlike an old debtor nation like Argentina, we are only at the bare beginnings of the process. By 1995 we shall be even more in debt. By 2000, even on optimistic projections of our current payments imbalance and its improvement, America will begin to owe an appreciable fraction of her total wealth and will have to pay out interest and dividends that begin to be an appreciable fraction of our total productive income. That is not yet the case.

D. Argentina is a debtor nation. Until recently, South Korea was going every year into international debt. But there was a world of difference between these two debtor cases.

Argentina's debts were largely incurred under a now discredited military government. Their proceeds went into graft, into Swiss numbered bank accounts, into high living. The present electorate in Argentina is left only with the IOU's to banks in New York, London, Frankfurt, Tokyo, Chicago, and San Francisco.

South Korea, on the other hand, ran payments deficits as money was lent from abroad as surpluses abroad vis-a-vis South Korea were cycled back into South Korea to build up plants, improve machinery in quality and quantity, and finance new productive ventures. Along with IOU's to foreigners, South Koreans are left with capital trees that bear new fruit and nuts and which enormously fructify current Korean productivity wages.

Now, which is the American case like? Is it like Argentina? Is it like South Korea?

Well, you know I am a critic of 1981 snakeoil supply-side economics, I testified at this very table in the good company of Republican critics like Herbert Stein, Paul MacCracken, Martin Feldstein, Henry Wallich, and Alan Greenspan; and of Democratic critics like

Franco Modigliani, Robert Solow, Walter Heller, Arthur Okun, and James Tobin.

I criticized the new supply-side economics, and all of us together were in remarkable agreement. I went home and had to reexamine my arguments when I saw the people I was in agreement with. I wrote down our prognoses. And this is one of those rare cases for an economist where you pinch yourself and say, "What went right with our predictions?" For once the expectations of mainstream economics were realized in the economic history records.

But objectivity can only help a strong case when it stresses the following simple truth:

America's debtor status more closely resembles that of South Korea—and Canada—than it does that of Argentina (and Peru). We do have swollen IOU's, but we do, so far at least, have much capital formation that would otherwise have been crowded out by Bush-Reagan fiscal irresponsibility. I should add that some of our borrowings in the Reagan years did add to our consumption in the Argentines.

Read my lips when I make this observation.

In concluding, there is time to correct the way we run the railroad of political economy.

The "we" here is the American electorate that I am addressing.

No irresistible wave of the future rolls us down the way to a rendezvous with Argentine-like disaster.

Thank you, Mr. Chairman.

[The complete prepared statement of Paul A. Samuelson follows:]

America's True Decline, without Exaggeration or False Optimism

Testimony for U.S. Senate Committee on Banking,
Housing and Urban Affairs:
Wednesday, November 15, 1989 at 9 AM
Paul A. Samuelson, MIT (Nobel Laureate, 1970)

At War's end in 1945, the United States produced almost half of global output. That was an artificial moment - - when Europe and Asia were devastated by conflict, and our economy was expanded by the fever of the war effort.

After the successful Marshall Plan and MacArthur Occupation, the U.S. share of world output dropped to 40 percent. The miraculous 1950s and 1960s in Europe and the Pacific Basin witnessed our fractional share of total production dropping to 30 percent.

Now in 1989 our 5 percent of the world population enjoy about 23 percent of total world income. This 1945-to-1989 dynamic change, I say both as an American patriot and as a citizen of the human race, has been a good thing and not a bad one.

The change came not from a failure of our performance in the 1945-1980 years. Actually, American growth was vigorous in those years, surpassing our rate of progress in the best epochs of our history under undiluted capitalism.

The great change came from the remarkable sprint by the Common Market and the Pacific Rim nations, in which they have reduced but not obliterated our gap of superiority over their technology.

Economics is unlike the zero-sum-game which is power politics. If Bismarck gains, Louis Napoleon loses in the struggle for power. However, when people in India and Taiwan and Spain live better and longer, the enjoyments of my American breakfast and winter vacation are not one whit lessened.

Historians do not understand economics. They write in sports page fashion. Here is how it reads:

> Once Rome ruled the world; then she lost her hegemony. So it was with the Spanish Empire. And, later, with the Dutch supremacy. The glory of Louis XIV's France bit the dust. Brittania ruled the waves and the lands they washed against under Queen-Empress Victoria. That could not last. It did not last.
>
> So with the American Ascendancy -- as cosmic historians fabricate their legends. Our pre-eminence is in permanent decline -- as Americans save less, learn less, work more languidly, engage in drugs, and countenance crime and disorder.

As an informed economist, I must correct quantitative distortions. I must paint the picture in its correct shades, neither darkening the bad spots nor white-washing the subtle and insidious degenerations.

Let me sum up objectively.

1. Yes, America is now the largest debtor nation, after being in 1980 the world's largest creditor nation.

2. Yes, the chronic budget deficits that go on at American

full employment -- which are harmful Reaganomics deficits and not Keynesian deficits targetted to offset recession -- do lower America's thriftiness. What is already our abnormally low private thriftiness is worsened by this public-sector negative saving rate.

This is the devil's recipe for a high-consuming U.S. economy. Without our use of foreigners' savings, as the Japanese and Germans recycle their trade surpluses, domestic capital formation would be crowded out in our fully-employed system.

3. Future American affluence and political power can be promoted only by capital formation in equipment and plant and in human-capital training and education; and by investments in pure science, technological know-how, managerial science and development.

So to speak, our trading partners use their trade surplus with us to plant new capital trees that would otherwise be crowded out and not get planted. The fruits and nuts from those trees of capital will be theirs not ours in America, and it is they that will provide the source for future dividends and interest that we must send abroad to them.

Fortunately, the productivity wages that our citizenry can earn in the 1990s and the new century will be enlarged because these foreign-planted capital items are available for Americans to work with.

It would be better if American voters compelled the structural deficit to be reduced toward zero -- whether this gets done all by expenditure cuts, or all by tax increases, or part by each. Either way, we private persons and corporations would have to cut down on our consuming. Either way, the same planting of needed capital trees would get done. But this time, those trees would be owned by Americans; and their nuts and fruits would accrue as enhanced future U.S. income, while at the same time, U.S. workers would enjoy the enhanced productivity wages that come from having more and better machines to work with.

Final Cautions

My allies in the crusade to reduce the structural budget deficit sometimes exaggerate. Let me conclude by correcting the record.

A. The inherited deficit -- call it the Reagan deficit, or the Reagan-Laffer deficit, or the Reagan-O'Neil deficit, or the Reagan-Bush deficit -- is an evil. But it is not the kind of an evil that entails a nearby recession or a nearby acceleration of inflation.

THE CHRONIC DEFICIT IS AN OVER-CONSUMING EVIL WITH INSIDIOUS LONGRUN CONSEQUENCES FOR AMERICAN MIGHT AND AFFLUENCE.

B. America has not been passed by in material affluence by Germany, Switzerland, Scandinavia, or Japan. Actually, if we call America's 1989 per capita real income 100, then none reaches our level. Closest rivals include: Canada, 93; Norway, 92; Switzerland, 88; West Germany, 84; Sweden, 79; Japan, 78.

By 1999 some of these gaps might be reduced, wiped out, or even reversed in sign. Japan is not likely to be the first in time to catch and pass us by.

C. America is now a net debtor nation. We are the greatest debtor nation in absolute terms. But unlike an old debtor nation like Argentina, we are only at the bare beginnings of the process. By 1995 we shall be even more in debt. By 2000, even on optimistic projections of our current-payments imbalance, America will owe an appreciable fraction of her total wealth and will have to pay out interest ~~and~~ dividends that begin to be an appreciable fraction of our total productive income.

D. Argentina is a debtor nation. Until recently South Korea was going into international debt. But there was a world of difference between these two debtor cases.

Argentina's debts were largely incurred under a discredited military government. Their proceeds went into graft; into Swiss numbered bank accounts; into high living. The present electorate in Argentina is left only with the IOU's to banks in New York, London, Frankfurt, Tokyo, Chicago, and San Francisco.

South Korea ran payments deficits as money was lent from abroad to build up plants, improve machinery in quality and quantity, and finance new productive ventures. Along with IOU's to foreigners, South Koreans are left with capital trees that bear new fruit and nuts and which enormously fructify current productivity wages.

Which is the American case like? Like Argentina? Like South Korea?

I am a critic of 1981 snakeoil supply-side economics -- in the good company of Republican critics like Herbert Stein, Paul

MacCracken, Martin Feldstein, Henry Wallich, and Alan Greenspan; and of Democratic critics like Franco Modigliani, Robert Solow, Walter Heller, Arthur Okun, and James Tobin. But objectivity can only help a strong case when it stresses the following simple truth:

> America's debtor status more closely resembles that of South Korea (and Canada) than it does that of Argentina (and Peru). We have swollen IOU's. But we do have capital formation that would otherwise have been crowded out by Bush-Reagan fiscal irresponsibility. There is time to correct the way we run the railroad of political economy. No irresistible wave of the future rolls us down the way to a rendesvous with Argentine-like disaster.

The CHAIRMAN. Thank you very much, Mr. Samuelson.

We have been joined by other colleagues. Senator Garn is here. Senator Pressler is here. Senator Bryan of course was here before.

Senator Garn wants to put his statement in just now, and let's just do that.

Senator GARN. Thank you, Mr. Chairman. I would just ask unanimous consent that my statement be placed in the record and say to Professor Samuelson I am one of those hundreds of thousands who also had your textbook. The only thing that amazes me about that as a 19- or 20-year-old taking it, I assumed that you were old then. [Laughter.]

And all is relative and now I find out you are still a young man 35 years later.

So thank you, Mr. Chairman.

[The complete statement of Senator Garn follows:]

STATEMENT OF SENATOR JAKE GARN

Today the Banking Committee will hold a second day of hearings on the condition of the U.S. economy. Yesterday, one view of the economy, a very pessimistic one, was forcefully presented by the witnesses. The information was well presented, and the witnesses are experts in their field. I do not, however, share their pessimism.

The list is not a short one of those over the past 7 years who have been predicting economic catastrophe right around the corner. Just a couple of years ago, several books predicted the onset of a great depression. While earning a great deal of money for their authors, the books were wrong in their predictions. These and other economic observers have consistently underestimated the resilience of the American economy. As with Thomas Malthus many years before, the effort to predict the future through the extrapolation of economic trends has run aground on the rocks of hard reality. Fortunately, that hard reality has in large measure been a pleasant reality, the reality that life is dynamic and that human ingenuity, if set free, has a way of overcoming adversity and often avoiding predicted catastrophes.

I am not saying that economic difficulties cannot come. If we were to adopt the formulas of some of these doomsayers and enact monstrous new taxes, increase government regulation and interference in the economy, return to the discredited mercantalist practices of past generations, then catastrophe could be realized. Frankly, I do not see that happening. I would oppose it, and I hope that my colleagues would as well.

With one point raised consistently, again and again yeserday, I do agree, and that is with the importance of reducing the Federal budget deficit. That is our job. We may not be able to do much in Congress to increase productivity, to better organize business relations, to boost creativity. But no dollar of Federal money was ever spent without congressional authorization. Our job is to bring down the deficit. I hope that we will not divert our attention from our number one job by pursuing goals and strategies in areas where we can at best only marginally help and possibly might be a hindrance.

The CHAIRMAN. Do either of my other colleagues want to put statements in the record at this point?

Statements from Senators Dixon, Shelby, and Kassebaum follows:

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee holds its second day of hearings on developing economic trends and their significance for America's future. I look forward to the testimony from Professors Paul Samuelson of M.I.T. and Lawrence Klein of the University of Pennsylvania.

One conclusion I drew from that hearing and from the written testimony of todays witnesses is that the budget deficit is at the core of these negative economic trends. Unfortunately, too many in Washington have viewed the deficit as a problem with no consequences, while the truth is that it does. The consequences—given the current economic context—are prolonged slow economic growth, stagnation in our living standards, a lack of resources to address critical problems—like drugs and the environment—and rapidly increasing foreign ownership of American assets. Those are not small consequences.

The truth also is that the deficit cannot be meaningfully reduced by 535 disparate elected Members of Congress. Strong Presidential leadership is critical. We have now had almost 9 years without such leadership. Congress has affected budget priorities, but the total spending it has approved has been pretty close to the amounts requested by Presidents Reagan or Bush.

I had high hopes for President Bush when he took office, but he has failed to lead. His administration has offered short term deals and bandaid approaches. A real proposal to reduce the deficit would, I am sure, meet with bipartisan support from Congress.

Yesterday, Professor Benjamin Friedman said that President Bush is "presiding over the decline of America as a Nation." I call upon President Bush to stop just presiding and to start leading us toward America's resurgence—by showing real leadership for ending this cancerous Federal budget deficit.

Mr. CHAIRMAN. Mr. Klein, Professor Samuelson is a tough act to follow, but you are fully capable of doing that. So we are delighted to have you and very interested in your thoughts this morning.

STATEMENT BY SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I appreciate your scheduling this hearing and inviting so distinguished a panel of witnesses. The issues to be disucssed today are vitally important.

I have read the written testimony and found it to be both enlightening and slightly more encouraging than that that was presented yesterday. However, I am not surprised that all the testimony shares the same common theme: the fiscal policies of the United States must be brought into line, we must reduce the Federal budget deficit. In failing to do so, we are shortchanging the future prosperity, indeed, the future standing of this country.

It is incumbent upon this body and the Congress as a whole to fix this fiscal mess. However, I am not optimistic enough to believe that we can do it without cooperation and leadership from the administration. President Bush has had a fairly successful first year. He has had his hands full in tackling problems left over from the previous administration and for the most part has done a satisfactory job. Over the past 11 months, this committee has seen firsthand the importance of Presidential initiative, with the passage of the Bush resolution to the thrift crisis.

Mr. Chairman, Congress will adjourn sometime in the coming days and weeks, returning next year energized and refreshed, ready to work on solutions to big problems. President Bush is scheduled to attend a floating summit with Gorbachev and I commend him for his amicable relationship with the Premier of the rival superpower. I serve on the Committee for Armed Services and could not be more pleased to witness the events going on around the world and what appears to be the true demise of the cold war. The Soviet economy is in a disastrous condition and subsequently the Soviet ability to finance a continued arms buildup is severely hamstrung. At this time, the most serious challenge to America is not to its military competitiveness.

Rather, it is our economic competitiveness that is currently under fire. Our rate of labor productivity continues to lag behind the rates of our trading partners. Our overconsumption has driven up the cost of capital, forcing businesses to limit research and development and to focus resources into investments that pay off quickly, thus undermining the future competitiveness of American industries.

I commend President Bush for scheduling a summit with Gorbachev. But I firmly believe that a domestic economic summit should be the President's most pressing engagement in the new year. It is important that Congress and the administration face this problem squarely, without accounting gimmicks and without partisan rhetoric.

Mr. Chairman, I believe that these hearings are extremely helpful in building a record of suggestions from experts. However, these suggestions will be useless unless we act on them. It is essential that we call upon the President to assist us in turning our fiscal policies around, before it is too late. Thank you.

STATEMENT OF LAWRENCE KLEIN, PROFESSOR OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA, PA.

Mr. **Klein**. Thank you, Mr. Chairman.

Most of you have acknowledged your economic nurturing on some edition of Professor Samuelson's textbook. I was his student when he was writing it.

The **Chairman**. I see. So we have all been infected by the same virus here at one time or another.

Mr. **Klein**. Yes.

Mr. **Samuelson**. Yes, but water can rise above its source, which Professor Klein has proved.

Mr. **Klein**. I am going to follow along the same lines. I accept the kinds of points that you, Mr. Chairman, made in your opening statements and that Paul Samuelson has made, but I want to summarize the paper, or the testimony that I put in the record for you. I won't go through the whole thing.

But in this testimony I am observing that both the United States and the rest of the industrial world—that essentially is Canada, Western Europe and Japan, Australia, and New Zealand—are enjoying an unprecedented prosperity, and the problem is are there gaps in that prosperity, are there trouble spots ahead, and will it last, and what kind of position has that put us in.

One of the obvious difficulties with the prosperity that we have at the present time is the problem of the twin deficits and, at the same time, the problem of a changing and declining American competitiveness. I personally don't think this decline is forever. Things in economics often get reversed. But in the present situation we do have very definitely a problem of international competitiveness.

In addition, I would like to say that when we look at the performance of the American economy and the other parts of the industrial world we generally judge them by main aggregates—total production, total income, employment—but the distribution problem is a very serious matter, and when Paul Samuelson mentioned some of the attributes of the affluent society and some of the problems, drug problems and other problems of youth, then we think back to the distributional issues. Among these there has been a worsening in terms of degree of inequality of the income distribution over a fairly long period of time—it started perhaps in the 1970's and has been accelerated—and the percentage of people living below the established poverty line and things that we see in everyday life—the homelessness. Anyone who lives in an Eastern urban environment can't avoid the homelessness problem. So we have succeeded in producing a huge GNP—and other countries have done the same—but we haven't succeeded in dealing with some very important economic questions, and that is the question of social stability, social equity, and the distribution of income.

Now, one aspect of the present situation I wanted to try to unravel a bit is the interrelationship between the deficits and money market conditions—interest rates, exchange rates, and things that play a great part in the functioning of the economy—and if you approach the interrelationships from the point of view of looking at what I would call two-dimensional correlations, you will find very little correlation between interest rates and debt or between exchange rate and current account position. However, there are very significant relationships. The problem is that they aren't very simple, and what I want to do is try to unravel those a bit.

In the first place, I presented a diagram with my testimony, plotting the current account deficit as a positive number and the federal budget deficit as a negative number, and there are two points in that diagram that I think are of extreme importance.

One is that the normal position—and I am not speaking about the distinction between structural and actual deficits, but the normal position for the American deficit in history has been a little bit plus or a little bit minus, but hugging the zero line, and the same is true of the current account deficit. On some occasions I have extended this kind of graph back to the beginning of the century and you become even more aware of the fact that the normal position is sometimes to be in surplus, sometimes to be in deficit, but not to be too far from balance in either the external account or the internal account, and I truly believe that our target for economic policy ought to be to get back to balance.

The second point is that the period since 1980 is truly a statistical aberration. It is something we haven't had in history. There are periods of war finance when something unusual happened, but if you exclude the war finance periods in going back to the beginning of the century, then I definitely conclude that this is an aberration that must be dealt with.

Now, I think the issue is that the existence of these deficits, certainly the Federal deficit, means that interest rates are higher than they otherwise would be. I am not saying that they are higher than yesterday or higher in any absolute sense, but higher than they would have been had we pursued a more prudent fiscal policy.

Now, the consequences of this have been that we have become, as has been already noted in this room, a low saving and not too high investment economy, and what we need to do is to switch to a high saving, high investment society, and the fact that interest rates are relatively high, higher than they otherwise would be, means that we are getting less fixed capital formation than we otherwise would have had, and in addition, as long as we are running a deficit at all—even if it is slightly improving on current account, the total debt is building up—and unless we get interest rates lower there will be a very considerable service charge.

That service charge was what Paul Samuelson referred to as the fruits and the nuts of the ownership of the assets which we have to pay out, and the same is true in connection with the Federal deficit. We must service it, and the servicing is an ever-present and increasing burden as long as interest rates stay high and are rising.

So the near-term prescription is very easy for us to state as economists, not so easy to legislate or administer, but it is a very simple prescription. Reduce spending, raise taxes, or have a combination of both and become more prudent in federal fiscal policy. Then we should accept the statements of what I believe are open statements or implied statements of Federal Reserve Chairman that they would accommodate that kind of fiscal prudence and deficit reduction. Therefore, we could keep the economy on a fairly even keel.

Now, at the present time I think it is worth inquiring whether we are in a cyclical position of some concern. I did start out by saying it is an unprecedented prosperity, and it is, but prosperities come to an end, and I would argue that we have not abolished the business cycle. There is no doubt that the American economy is slowing at the present time and has been slowing for several months. There is some doubt as to whether the slowing would turn into a recession or not, and that depends on the adroitness of the monetary authorities unless they get an assist from the fiscal side, and we have a combined policy of fiscal prudence and monetary ease.

But at the present time we are left with monetary fine-tuning, and we would have to hope that monetary fine-tuning would solve the problem.

Now, there is an additional difficulty at the present time. It is not only the Federal debt, is not only the international debt that we have built up through the current account deficits; it is also a question of the overall indebtedness in this country. If you will look at statistical charts of debt holdings in the private sector, in the private business sector, the private household sector, financial sector, you are aware of the same kind of position, that we are far from normality and we have been since—probably since the early 1980s, not quite as early as the charts that I presented, but since the early part of the 1980's the debt holding has balooned in the private sector of the American economy.

Now, I think this is a very serious matter when the economy slows down. If we were to go into a recession or even to a slowdown, bankruptcy rates will certainly become more serious and the ability of many parts of our economy to manage their debt or service their debt in a recessionary period or a slowdown period is a matter of serious concern.

I have recently looked over the historical statistics for the 1980's and find that on revision of the GNP figures from last July there was something we would call a mini-recession in the early part of 1986. We had between the first and second quarters a decline in real GNP, by the latest figures, of minus 1.8 percent annual rate, which is a nontrivial number, and at the same time if you will look at bankruptcy statistics and other statistics that are associated with the debt position, you will find that they worsened, as did the unemployment rate in that very brief period.

Now, I think we came out of that near miss by changes in the world oil market that were not part of our doing, but something that happened to the world.

So the problem is that we are quite vulnerable, and we are quite vulnerable to an adverse turn in economic events. If you assume, as I assume, that we haven't abolished the business cycle, then we are subject to that degree of vulnerability.

Now, as far as the dollar rate is concerned, if we have to go to a situation of higher interest rates and if interest rates are higher than they otherwise should have been, it is likely that the dollar will be somewhat higher than it otherwise would have been, and this is standing in the way of our improving our trade balance and the current account balance.

So there is not a perfect correspondence between exchange rates and interest rates, but certainly if interest rates decline in the United States, the dollar will tend to fall unless our partner countries also lower their rates. If they would keep their rates steady or raise their rates, then the decline in American interest rates would probably bring a depreciation of the dollar, which would probably be beneficial for our foreign trade accounts.

So we have to look at very complex interrelationships. They aren't simple, but they are certainly there.

Now, that really deals with the near term—in very summary form—the near term situation for the American economy.

I think that the policy initiatives that you are responsible for should be addressed to a lot of the medium term and longer run problems.

There is no technique that is better than raising productivity and improving competitiveness, as far as improving the current account is concerned. We can do something about trying to change Government policy, trying to affect interest rates, trying to affect exchange rates—and in a sense we have relied on exchange depreciation as a crutch—and the crutch has been in place of turning around productivity growth, becoming more cost effective in world markets, raising the quality of our products so that we are fully competitive.

I presented some statistics in my paper dealing with the growth of American manufacturing productivity per worker—per worker hour. I think we are doing fairly well, not the best, not the worst. We did very poorly in the 1970's, but in this decade we are right in the middle of an international distribution of productivity growth rates. Those refer to manufacturing. The manufacturing sector is being displaced in percentage terms to a certain extent by the services sector, and in the services sector there are more problems with productivity growth. The figures are not so buoyant as far as service rates are concerned, but it is also much more difficult to measure productivity in the service sector.

Now, I would say the fact that we are not the worst, or that we are not the best, means that there is a possibility of improvement and room for improvement, and that is where longer term policy must look—to improving worker training, to giving more support to the educational sector, to give more support to civilian R&D—and this I think should be in the long run—and by "long run" I mean 2 or 3 or 4 years. Results will begin to show up in better productivity and more cost effectiveness—better competitive position—but gains will continue for a long time to come and not just for the few years ahead. That is obviously the kind of economy we ought to be aiming for, the higher saving, higher investment, higher productivity economy that is more efficient. I think if one goes in that direction, then we could be fairly optimistic about the 1990's, even if the business cycle hasn't been abolished and we are heading for a cyclical correction.

Now, it is most likely to be a correction of a normal type—the type we have had since the middle of the nineteenth century—at least as far as records are concerned. But if you look at the whole period, say, to the end of this century—for the decade of the 1990's—then I think one could take a fairly optimistic view. We could have a very good growth, but I would say it is up to you to get together with the Administration to implement the kinds of policies, both for the near term and the medium term, that have been suggested.

Thank you.

[The complete prepared statement of Lawrence Klein follows:]

Diagnosis of Contemporary America Economic Problems, November 1989

Testimony prepared by L. Klein

for Hearings of the Senate Banking Committee

November 15, 1989

The present economic expansion in the United States dates from November 1982. It is an impressive expansion, with inflation well controlled, and it has provided a period of extremely good prosperity. There are, however, serious problems in the overall performance, some of them subtly interrelated and not obvious to all observers. I intend to highlight the main problems and try to cut through the interrelationships in a way that points to some policy recommendations.

First, it must be stressed that the favorable points of the overall description of this prosperous episode in our economic history refer to aggregate magnitudes. There are several disturbing aspects of the distribution of income and consumption from which the aggregates are derived. Income distributions have, for some time, been trending towards increasing inequality. The number of people living below the poverty line has been increasing and many social ills have arisen in diverse sectors of the economy. Urban dwellers cannot avoid seeing the increase in homelessness. Substance abuse is rampant -- at many economic levels -- but all too much among discouraged and neglected economic groups. Children are being brought into unattractive environments inferior to what a prosperous country should be able to provide. Reforms and legislative changes in our system of taxes and transfer payments have been achieved without proper regard to these distributional problems.

At an aggregative level, we still have an oversized federal budget deficit that is artifically diminished by the accounting treatment of the savings and loan crisis or the natural disasters of 1989.

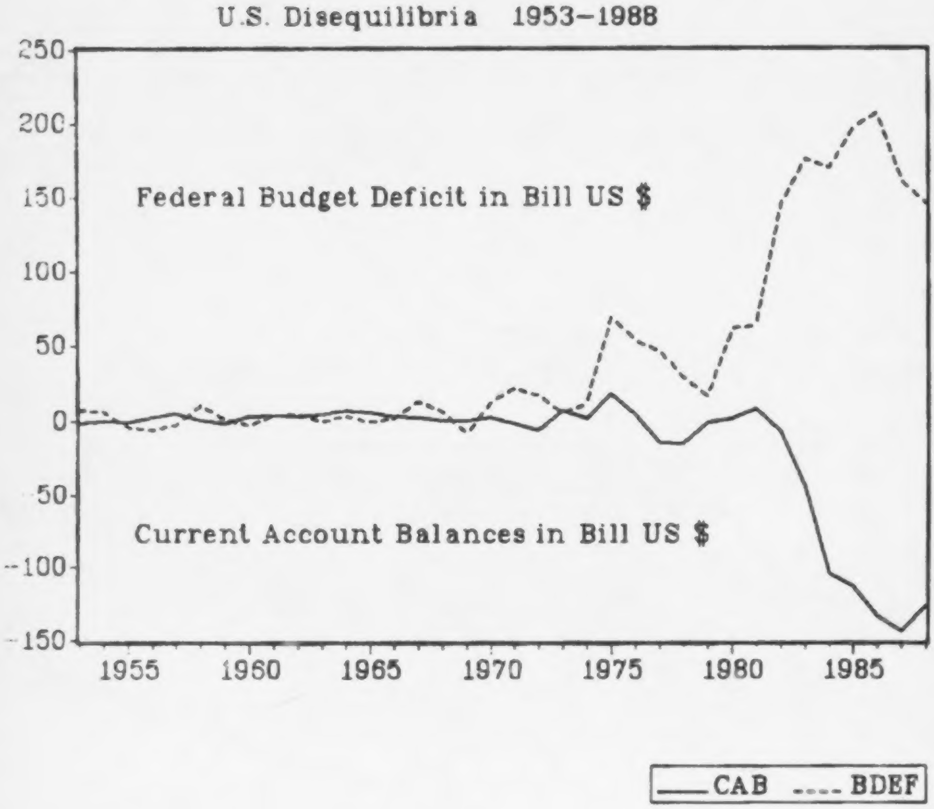
Our external deficits (on the current account, on the goods and services account, or on the merchandise account) have not vanished. The total debts associated with the annual recurrence of internal and external deficits are growing and posing serious service burdens. The personal savings rate continues to be very low, and our competitive position in the world economy is only fair. We should aspire to the best if we were fulfilling our historical leadership role in the world economy. Our financial markets have exhibited frightening degrees of volatility. These are not the only macro economic problems that we face, but they are the most serious ones, and I shall concentrate on them in this presentation.

Consider first the twin deficits -- the federal budget deficit and the current account deficit. A graphical display of the time pattern of these two deficits suggests two things.

(i) Except for understandable departures from the norm in wartime, the usual values (I suggest equilibrium values) for these two deficits are zero. This is very important because it means that we should not be satisfied with attempts to reduce them to values that are significantly lower than today's

FIGURE 1

Twin Deficits of the United States



but significantly larger (in a deficit sense) than zero.

(ii) The tendency for these two deficits to swell after 1981 is surely an aberration, not part of the normal pattern, and something to be eliminated.

Many people have remarked that the continuance of the favorable expansion that began in 1982 is evidence that the deficits do not matter, that the economy does not function as it once did, and that there is no apparent relationship between these deficits and such market indicators as interest rates and exchange rates of the dollar. The expansion has continued through periods of both higher and lower interest rates than we have today and through periods of both rising and falling dollar exchange rates. What is wrong with this perception?

It would be nice if one could consider a single cause and single effect to get answers in economics but, in reality, there are many causes, many effects, and many interrelationships simultaneously interacting to generate the very magnitudes that we are interested in, such as the deficits and market rates. Some degree of simplification is necessary, but it would be misleading to look at only one cause and one effect in simple pairwise fashion.

First, it is helpful to isolate factors that are under the control or influence of policy makers. The net foreign balance depends on market outcomes that are heavily dependent on decision-making by our international trading partners. We cannot simply make the foreign balance fall into place, as we would like to have it. The same is true of interest and exchange rates. They are market determined. Our policy makers can intervene by buying and selling government securities or foreign exchange, but the policy makers do not constitute the whole market. They can influence the markets for short periods of time and can do well in keeping markets orderly, but they do not control the markets. Ultimately, rates will go where the market wants them to go. On the other hand, public authorities can control federal budgets through spending and taxing decisions. Allocations, appropriations, outlays, tax rates (not collections) and transfer payment rates (not total payments) are under direct control. This is why we should start our analysis with the federal budget.

The domestic deficit could be reduced if the Congress and the Administration had the will to do so. The process would not be painless, but it could be done. If the federal budget deficit were reduced, not all at once, but steadily, by significant amounts, forces to reduce income and production would be set in motion, but these tendencies could be offset. Federal Reserve authorities have often indicated that they would ease monetary conditions if federal fiscal conditions were improved. An accommodating monetary policy that would be phased in with a restrictive fiscal policy could maintain the present pace of economic expansion or even improve upon it.

This could be enormously beneficial, because a smaller public deficit would reduce the Treasury's need to raise funds on the capital market, work towards bringing down interest rates, and, given coordination with partner countries, could bring down the exchange value of the dollar.

The consequences would be

(i) reduced service burden for the public debt;
(ii) reduced transfers of interest payments abroad, improving the current account deficit;
(iii) more favorable export prices and less favorable import prices, which should reduce the current account deficit;
(iv) lower costs of capital in the domestic market, a stimulus to domestic capital formation.

This chain of events, should make clear the interrelationship of the twin deficits and market rates. Unless all the policy measures are implemented simultaneously, we may not get the desired outcome, and some of the pairwise relationships could be reversed or blurred.

The indicated changes in macroeconomic policies are very important, especially those associated with international coordination, but the public authorities should pursue their policies further. There should be more finely tailored policies to deal specifically with the saving-investment process, international competitiveness, and national security.

I start from the assumption that households in our country save relatively little, and, correspondingly, consume an inordinately large fraction of our production. I believe that we would be better off if we were to save at a higher rate -- given our income position -- and if conditions were to be made favorable for channeling the higher rate of saving into capital formation of a sort that would generate a future income stream. We would then have a national economy that more closely resembles these economies whose performances we admire at the present time.

It has not been easy to raise the level of saving activity, but the cancellation of tax benefits for IRAs in the Tax Reform Act of 1986 was surely a step in the wrong direction. Tax reform was so heavily focussed on various microeconomic equity arguments that it paid little attention to macroeconomic consequences. Not only should the tax concessions accorded to IRAs be reinstated, for savings' sake, but the investment tax credit and highly accelerated depreciation allowances also should be restored. A return to some traditional progressivity could offset Treasury revenue losses and even be calibrated so as to increase revenues. These changes are aimed to bring about both high savings and investment activity. Nationally we should aspire to our historical savings rate of about 10 percent of personal income and join the ranks of the well run economies of the world.

Another lead to pursue for increasing saving is to make pensions more portable, so that workers can generally carry their accumulated reserves from job to job, much as the academic profession under TIAA-CREF can do when moving from one employer to another.

There is a great deal of evidence to support the view that the recent surge of activity in buyouts, mergers, acquisitions and other financial maneuvering among corporations drains revenues from the Treasury. Curbs on these activities could help the Treasury, reduce stock-exchange volatility, and set corporate management on a track to do what it ought to be doing, namely tending to business affairs so as to raise economic efficiency. In this respect, it should be stressed that exchange rate changes should not be relied on excessively to increase competitiveness. Nothing can do more than our becoming more efficient by raising both worker and capital productivity.

The United States went downhill with respect to manufacturing worker productivity during the 1970s in tandem with most other major industrial countries. We were neither the worst or the best during the 1960s and 1970s, but were quite low in the distribution across countries. During the 1980s, however, we have started to recover. Recently our productivity gains have been respectable enough to put us in the middle of the distribution for the 1980s. This can be seen from the comparative international tabulations by the Bureau of Labor Statistics.

Table 1

Worker Productivity Growth in Manufacturing

(% change)

	1960-73	1973-79	1979-88
US	3.2	1.4	3.3
Canada	4.5	2.1	2.2
Japan	10.3	5.5	5.8
Belgium	6.9	6.0	5.4
Denmark	6.4	4.2	1.1
France	6.4	4.6	3.1
Germany	5.8	4.3	2.6
Italy	6.4	5.7	4.1
Netherlands	7.4	5.5	3.5
Norway	4.3	2.2	2.6
Sweden	6.4	2.6	3.0
UK	4.2	1.2	4.7

Source: Bureau of Labor Statistics

The fact that the recent performance of the United States was not the best indicates that we could aim to do better. The fact that our productivity growth was not the worst shows that there is hope. Gains in productivity, in the near term, are mainly a matter of private behavior that will have to be fostered by U.S. industry at the source, possibly by paying as much attention as possible to developments on the "shop floor." In the longer run, public support of and commitment to training, education, research and development can make a difference. This is a matter of public priorities. In a restrained budget it is particularly a matter of priorities, and high priority should be devoted to these areas of our national life.

Will the present expansion, now seven years old, continue indefinitely?

If we undertake policies of the sort that I have indicated, the expansion can be continued, but I am a firm believer in the law of the business cycle and feel confident that a turn will eventually appear. Towards the end of the 1960s it was widely thought that the business cycle had been eliminated. There are some interesting statistical analogies between the decades of the sixties and eighties. An expansion began in February 1961 and continued without an "official" recessionary downturn until December 1969. There was an interesting development, called a mini recession in 1966, when real GNP fell for one quarter, from 1966.4 to 1967.1 according to preliminary data (which have since been revised; the decline has been changed to a small increase). This was a period of escalation in the Vietnam War, and the short-run effect undoubtedly related to the prolongation of the expansion until 1969. Just when some economists thought that fiscal fine-tuning could do away with the business cycle, it reappeared, and downturns again occurred in November 1973, January, 1980, July 1981. Periodicity was not completely regular, but our country's long history of a four-year cycle average was sustained.

Faulty data indicated a very slight increase that was then revised to a slight decrease in real GNP between 1986.1 and 1986.2, but it hardly drew comment as even a minor recession. The data revisions of July 1989 now show that a much more pronounced drop occurred between these two quarters, at an annual rate of 1.8%. This drop might be called, in retrospect, a mini recession but did not develop into something more noticeable because the world oil market fell drastically at that time and helped the American economy -- just the reverse of the oil price increases that were instrumental in bringing on the recession of 1973-75, and 1980. Corroborative evidence of a mini recession in 1986 is shown by the increase in business failures at the time of the drop and an increase in the unemployment rate from 6.7 in January to 7.2 in May.

At the present time, we are in a growth slowdown. The economy is growing at a meager rate of 2.5 percent, below our trend potential. Our vulnerability to the risk of business failure is considerably enhanced by the high degree of activity during the past few years in buyouts, mergers, and acquisitions that were heavily financed by low-quality debt. Recent troubles in the junk-bond market and serious debt-servicing problems of very large buyout companies provide a warning of possible future difficulties. It is very difficult to pinpoint a recessionary downturn with precision at a quarterly frequency, but my reading of short-run indicators, at a monthly frequency, indicate that growth of the American economy during the next two quarters will be less than 2.5 percent. It is time to pay heed to policy measures that need enactment but are not getting adequate attention now.

The **Chairman**. Thank you very much.

We have had other members join us. Senator Gramm has joined us. Senator Heinz. I know Senator Heinz probably—I am going to begin the questioning in a second—but may want to make a comment because, of course, he represents your State and I know he is very proud to have you here today.

Senator **Heinz**. Mr. Chairman, I do appreciate the opportunity to welcome Larry Klein, who over the years has been before both this and the Senate Finance Committee testifying, as always, with great erudition and a lot of insight.

Larry, we are delighted you are here. Thank you very much.

Mr. **Klein**. Thank you.

The **Chairman**. I want to take, also, account of the fact that Senator Dixon was here and had to leave for another meeting and hopes to come back.

I am very interested in what you have had to say, and I appreciate the time and the thought that has gone into the presentations today.

I find that the wealth of information that I see from not only from other expert witnesses such as the kind we had yesterday, but business people who come in, all kinds of anecdotal information that I see in terms of how we are doing in different economic sectors and different areas of the economy, I end up with a greater sense of urgency than I think I am detecting here.

Now, I don't want to make that presumption because you are both very measured men and you speak with precision as to what you are saying, but in the case of you, Mr. Klein, you think—if my quote is right here—that we are quite vulnerable if we don't make some policy adjustments.

Professor Samuelson, you are recommending policy adjustments, but I didn't get any great tone of—and perhaps this was just my not picking up on it—of urgency and saying, look, you guys, the string is running out and you had better make these changes or you are going to inherit conditions up the road that you are not going to want to have to deal with. I didn't get too much of that sense, and you may want to correct me if that is a misimpression on my part.

I would like to express to you a little bit of why I have a much greater sense of urgency and just test why I have it against your thinking to get some reaction from you, and I want to—I have tracked these things on some charts that I use, and I found this one, Professor Klein, that you put in here, figure 1, to be very interesting, and it obviously is so far outside the norms that, you know, whether you were in a chemical laboratory or on a plant floor looking at defect rates or something else, if you saw something suddenly widen out so far off the historic norm you would say, you know, something is haywire, and maybe it is a whole lot of things in combination that caused this, but I attach a great significance to this, as you obviously do as well.

I just want to show you three charts, and then I want to make a point and get a reaction from you to it.

If you look at how our trade deficit has developed just since 1969 off a zero or a balance level in a chart notched in $20 billion segments, you certainly see this exponential change as we get out into the 1980's. Now, obviously there a lot of things at work here—the rest of the world really coming online after World War II, our internal problems in terms of the deficits and the perverse effects they were having in terms of interest rates and other things.

But if you think of that as sort of an income statement on just the trade side, where we have had this huge structural trade deficit develop and continue, if you look at the balance sheet—and you have both made some reference to this—I find this a very stunning chart in a lot of ways, where you see the situation where in fact we were the creditor nation, again a balance line running across here going all the way back to 1914, and that we worked that off quite rapidly in the mid-1980's and moved down across into this debtor nation status, and then I have put the quarterly add-ons out there as they have come in and are able to be posted, and there are two or three things that jump out at me here.

One is, first, the absolute level of this new negative balance, that we are down to about $650 billion-odd that we owe the rest of the world and it is growing at the rate of about a billion dollars every 3 days net.

But something that is even more powerful in my mind, just as a person who has tried to make sense out of charts and data over many years is how much has happened in such a short space of time.

In other words, when I say to myself what does it mean that we have gone—I don't want Senator Bryan not to be able to see this either—but what does it mean when we go from here down to here in a period of less than 5 years? In other words, there is a velocity issue here and a time compression issue here; that is, if this were stretched out over a 20-year time span or a 10-year time span I think it would have an entirely different meaning than when suddenly you find yourself riding a curve down at this rate of speed.

And I have tried to think, you know, what are analogous things that I have seen that show that kind of rapid change in circumstances, and the thing that came to my mind, there was a midair collision out in California a few years ago and a small plane hit a large commercial plane, sheared off part of the tail, and an amateur photographer happened to be there and catch the shot of the commercial plane coming down and it was coming down at just about this rate of descent; in other words, this is a rate of vertical descent that to me expresses something really quite extraordinary, especially when it is so far off the national norms.

If you take that chart—I just want to show you one other, and then I will put the charts away here—if you look at the buildup at the same time we are running up this international debt, if you put our Federal debt on top of it, where you have also had—and I think they are clearly interrelated—this exponential change in the aggregate of total outstanding federal debt, going from roughly a trillion dollars at the beginning of the decade, this decade, and now being at $2.5 trillion, you have got two charts that in a sense tell you the same thing. I mean, you have got two extraordinary breakouts of what I would call adverse circumstances.

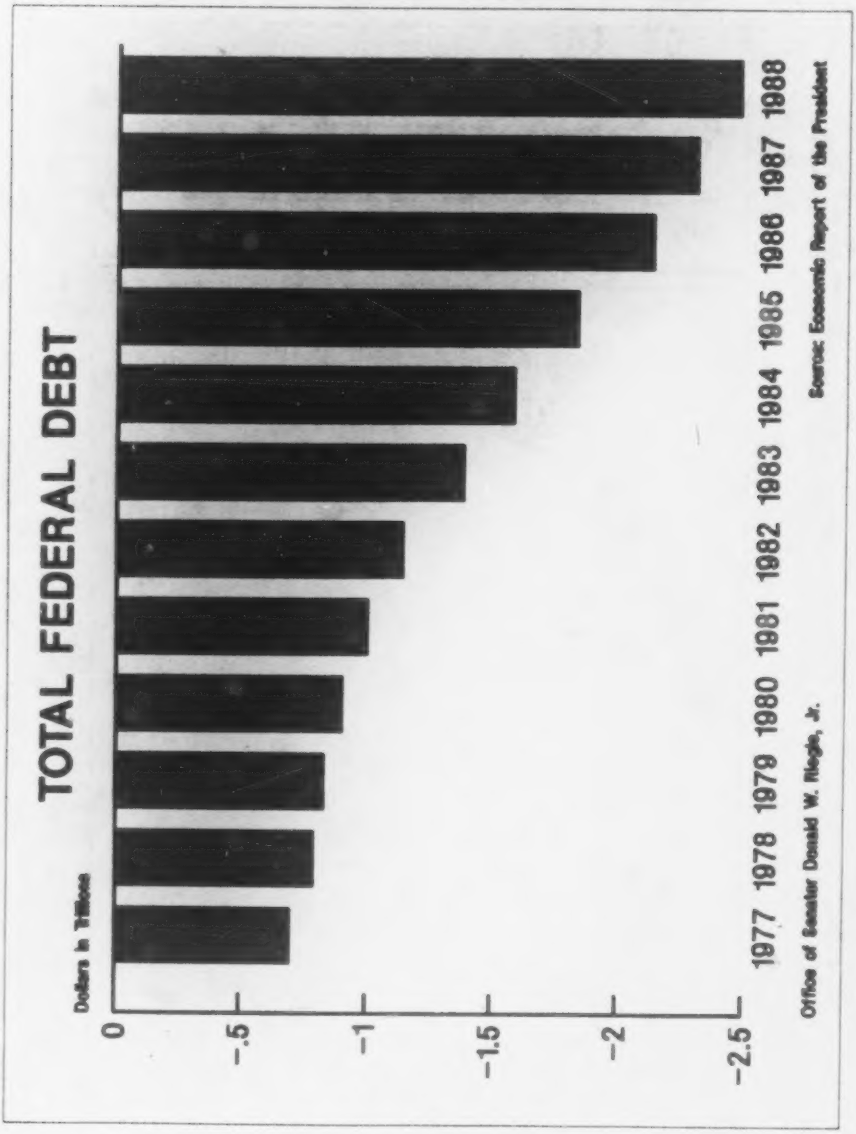
Now, I am not sanguine about an automatic turnaround; in other words, I don't think that things are in place or even on the horizon that will by themselves bring about an orderly readjustment. I think the savings rate problem, the capital investment problem, the fact that the rest of the world is going full tilt and we haven't even decided yet that we have a problem means that these trend lines are going to continue, and I see us increasingly being put in a straitjacket of difficulty because of the fact of our reliance on all this foreign borrowing, having to rebate all of the fruits and nuts to foreign owners and foreign debt holders, and so forth, and it seems to me that we are in a sense squandering our opportunity to really have the kind of strong future that bears any relation to the past of two or three decades ago and it really is a very urgent matter and unprecedented.

I mean, if you can show me a time in contemporary history where the United States has been remotely in a situation like this and where the rest of the world has gotten the head of steam that it has, I would like to see it. I don't know of it.

And I guess one other thing I would say, and then I would like your reaction, and that is I think when you start comparing countries we have to be very careful the degree to which we compare ourselves with Korea or Venezuela or Norway or somebody else. I mean, they are interesting comparisons, and they can be useful comparisons, but in terms of the international economic dynamics and geopolitical dynamics, the United States is in a league of the so-called power players of nations. We have got Europe 1992. We have got the Pacific Rim countries. We have seen sort of the collapse of the communistic system clearly, but they will be back into the game one presumes at some point.

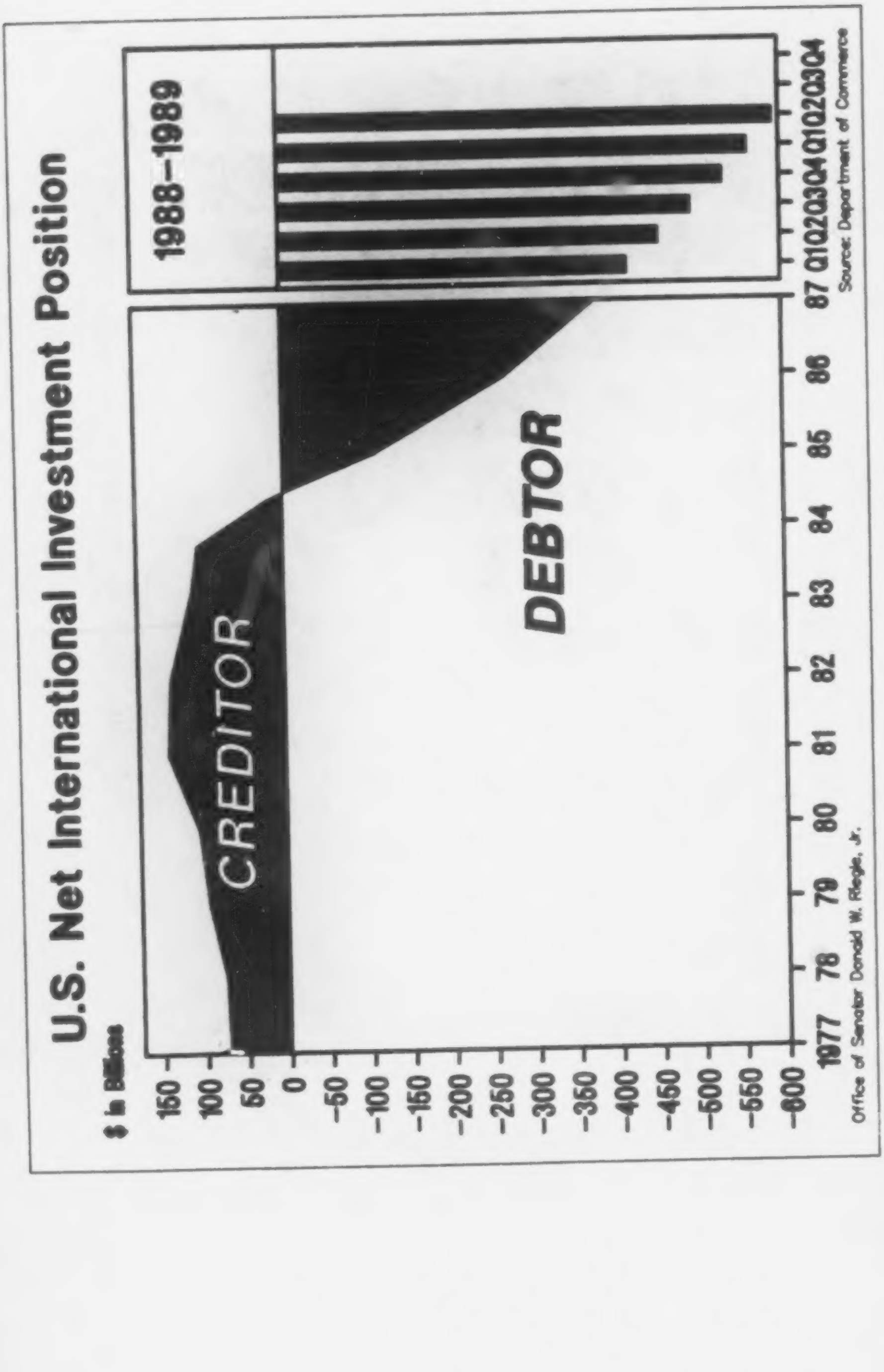
I think when you start making comparisons about the importance of a sophisticated economic strategy for the United States you can't draw much comfort from relating that to what I would call other sort of secondary or third level nations sort of on the international power scale. Our situation is different. Our responsibilities are different. Our obligations around the world are different, and therefore we have to operate and gear ourselves up to a different level of sustained performance than is in any way directly, I think, relevant to other nations, important in their own right but that just play a different role on the world stage.

I would like both of you, if you would, to react to that. Let me ask you, Professor Samuelson, if you would first.



Source: Economic Report of the President

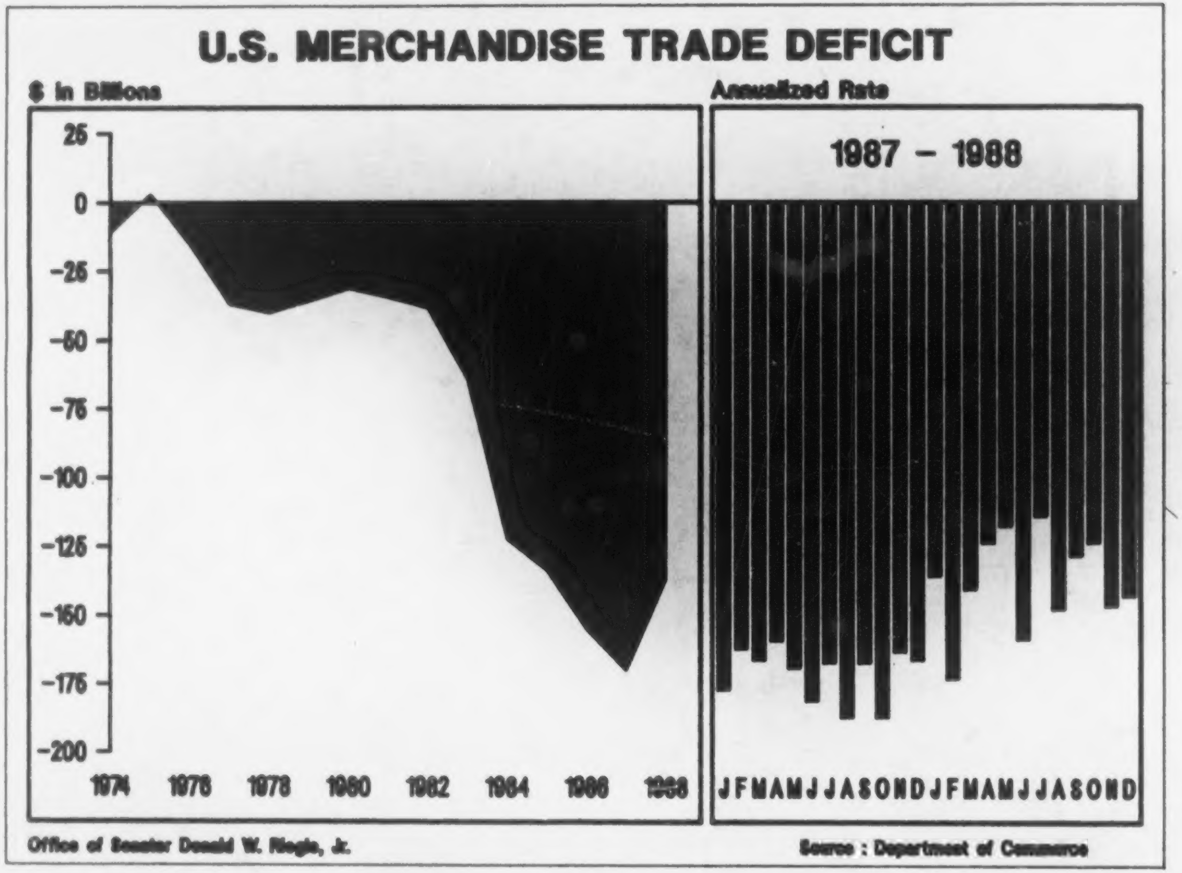
Office of Senator Donald W. Riegle, Jr.



U.S. Net International Investment Position

Source: Department of Commerce

Office of Senator Donald W. Riegle, Jr.



U.S. MERCHANDISE TRADE DEFICIT

Office of Senator Donald W. Riegle, Jr.

Source : Department of Commerce

Mr. Samuelson. Well, I hate to discourage native fervor because there is so little of it, but I am under oath.

The case of the airplane that you described is one of grave concern because you know that within a matter of minutes, not hours, not years, not decades, there is going to be a crash.

I could exaggerate. I have spoken of the evil of our twin deficits, but I have had to emphasize that it is an insidious evil.

I could give you a sermon against the end of barley corn. In the cases of alcoholics, it has done tremendous harm.

But to say to a young person on the threshold of such a syndrome. "The next three drinks are going to kill you," is to be discredited in about 1 week as an expert witness. Still, in 18 years his liver is going to tell him that everything you deplored is true.

The **Chairman.** Right.

Mr. Samuelson. We are talking about an evil which doesn't produce a business cycle day after tomorrow. It doesn't produce a recession in a systematic, predictable way, doesn't predict an acceleration of inflation in the short to intermediate term in a systematic, predictable way. For most people—I have testified for many years before committees like this, I have testified before chiefs of states, and there are only two things that most of those people are interested in.

If you can tell them there is going to be a recession unless you do A and B, and you have a persuasive, objective case, then you will be heard. If you can tell the Prince, unless you do C or D you are going to have an accelerating inflation that will curl your hair, you will also be heard. Almost everything else is a yawn.

Well, in economics there are a lot of other evils, and the overconsuming economy with an increasing ownership of what capital formation does take place by non-Americans is an evil. I even use capital letters in my testimony.

But I will not say that it is other than a long-run insidious evil.

It is true that your chart gained dramatic emphasis because when you go from plus to minus, that is a qualitative change, but actually the $1 that takes you from one-half dollar plus to one-half dollar minus is not a different economic change. It is just something that even the yokels can see.

So that——

The **Chairman.** If I may ask, though, if you have got a swing of 700 billion in 5 years, that is an awful different than going from $1 plus to $1 minus, and I concede your point and I am not suggesting by my airplane analogy we are headed for a crash. I don't mean to make that argument.

I am talking the dramatic change in a very short period of time. In other words, that suggests to me there is a whole lot going on that has piled up, that you have got sort of a critical mass of factors and it is a trend line you better get off.

Now, I am not—and I respect and recognize the capital letters, but I guess, you know, maybe it is just difference in words. Maybe you are in effect saying get off this trend line, that it is going to take you to a bad place. Even if it is not tomorrow or 2 years from now, it is 10 or 15 years down the road, you better get off this curve. I guess that may be what you are saying.

Mr. Samuelson. That is what I have said. There are elements of exponential increase in what you describe, and I have to confess that I was astonished that we could use up the patrimony accumulated from 1914 to 1980, in really the years of our supremacy, in about 5 years—surprised by the speed of that.

Nevertheless, as a debtor nation we are at the beginning of the process because objectively you must compare how much of a debtor nation we are now in comparison with our total GNP and with the other meaningful measures. I think the way things are going you are going to ask me back in 20 years and——

The Chairman. I don't think it will be that long. I think it will be much sooner.

Mr. Samuelson. And it is going then not to be at the beginning of the process. I think I will depend on you to make the emphatic case. I will try to stick with the analysis.

The Chairman. All right, very good. Well, I mean albeit with capital letters here and there.

Professor Klein, I just want you to have the chance to respond, and then we will yield to my colleagues here.

Mr. Klein. I want to pay a little bit of attention to the current account, the external deficit. There are three measures that we look at.

One is the merchandise deficit, which is what you showed, in effect.

The Chairman. Right.

Mr. Klein. Second is the goods and services deficit as we record it in the national income accounts, and the third is the current account.

Now, there has been a very significant change in our numbers. The statisticians have revised the goods and services so that our deficit is suddenly reduced to an order of magnitude of $50 or $60 billion. It used to be over $100 billion.

So if you look at that aspect—and you should look at all three, of course—if you look at that aspect, then you say we may have turned the corner, that all of the dollar depreciation was not for naught; it did some good. Our problem is that it is working too slowly and by too small amounts, but it is working, and the reason the merchandise status looks rather much poorer, though that could improve, too, than the goods and services deficit is that services have been understated. Now our Commerce Department has made a very significant increase in the services balance, so that there is some headway being made.

Now, second, we could do something more, much more about the merchandise. The kinds of things I talked about in terms of productivity and competitiveness do it perhaps in a few years, but we used to have a much bigger agricultural surplus than we do now, and we probably aren't going to get that back because new players have come into the process in our main export markets of corn, soybean, and wheat. But we could do something about the big oil deficit. That is a crying need. This country really doesn't have a good energy policy, has not had an energy policy for several years, and it is a shame that once the oil price broke our imports in terms of barrels per day went up by almost 30 percent. That I think is a very serious issue.

Now, as far as the current account is concerned, that is very closely associated with interest rates, and if we could move toward better domestic fiscal policy—and that is why people say the root of the problem is the fiscal deficit—that is something we can do something about. If we could get interest rates lower, then our service charges that go into the current account on Federal Government transfers paying interest abroad would be considerably reduced.

So either the situation is slightly improving or the situation is one that is crying for action here on your part and on the Administration's part to get the federal deficit down, to get the money markets in better shape to service the debt, and then we would be much better off.

The CHAIRMAN. Thank you. There is a lot I can think of I would like to pursue.

Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman. Thank you very much.

One of the issues, Larry, that you talked about in particular was the Federal budget deficit. A number of us have for quite some time been trying to strip away some of the illusions about the Federal budget deficit, that it is only—if you will excuse the expression—around $100 billion or $115 billion this year. I say it is an illusion on the basis that we believe that the Social Security Trust Fund surpluses that are building up in fact really will have to be paid to the Social Security beneficiaries who in fact are contributing to that trust fund now. Those contributors are in large part the baby boom generation. Their retirement will be financed when they retire in the years 2015 and thereafter by, in part, that surplus. We are worried that the Government spends that surplus of revenues over expenditures in the current Social Security Trust Fund accounts, which this year will be about $68 billion and is expected to rise by the end of this decade to well in excess of several hundreds of billions of dollars annually? Consequently, there will be no prospect of in fact repaying the Social Security Trust Fund because as the debt builds up it would be $3 trillion in constant dollars and $9 to $12 trillion, depending on your assumptions, in current dollars.

The question is where would the Government on top of its already large and growing debt get the money to make good? Would it default on the Social Security Trust Fund? Is that what we want to do?

So many of us believe that the right answer is to face that problem now by, in effect, taking the Social Security Trust Funds out of the annual Gramm-Rudman-Hollings deficit reduction calculations and targets, so as to force the Government to put money aside for those obligations.

My question is, is there any disagreement between either you or Paul Samuelson that that is good policy, and if there is disagreement, why? If there is not, is there anything you would like to add?

Mr. KLEIN. Well, I have no disagreement at all, and I would encourage your idea that policies should be undertaken now to meet that burden for 2020 or 2015, when it occurs, and it is building up. There is no doubt about that.

A way of meeting it, though, is not by taking it out of the budget; that is, I think we take too much out of the budget. We shouldn't have taken the savings and loan bailout out of the budget. We shouldn't take any emergency relief for the natural disasters of this year over and above the contingency funds out of the budget. Everything should be in the budget, and the Federal Government should plan ahead for contingencies.

Senator HEINZ. How about simply taking it out of the Gramm-Rudman-Hollings annual deficit——

Mr. KLEIN. The calculation.

Senator HEINZ [continuing]. Calculation and effort, so that whether it is off budget or on budget we understand that we shouldn't be treating that money as if it is a deficit reduction?

Mr. KLEIN. If you want to make a good formula—and I would certainly want to scrutinize the formula—for making—forcing a budget adjustment, if that were out, you would have to have what I would call the best forecast available and not assumptions about what the economy is going to do, but true forecasts as well as we can make them, then I think we could make the whole calculation, let's say, more honest and more usable.

So there is a formula for dealing with it, but I think the thing to be emphasized is the fact that we should undertake some policies to deal with the ballooning deficit, and just as a starter I would say the retirement age is ridiculous. Both my teacher and myself at this table are above retirement age, but we haven't retired.

Senator HEINZ. Well, that may be an issue that is worth looking at in itself, but even if we raised under Social Security the retirement age to age 70, we are still going to need the surplus that we are planning on.

Mr. KLEIN. Yes. That is only one among many things.

Senator HEINZ. It may be good policy, but it doesn't bear on what we do in the coming years.

Mr. KLEIN. It would bear on the size of the deficit, wouldn't it?

Senator HEINZ. No. No, because the time that raising of the retirement age is going to have an effect will be two decades from now. I don't see any realistic prospect we are going to raise the retirement age during the 1990s. Normally, Congress gives people notice on something, substantial notice, in the frame work of 15, 20, 25 years. So it is unlikely to have much impact.

Second, even if we did it tomorrow the fact is that we would still have the issue of growing those surpluses. If we continue to have surpluses like we do today, there will be no improvement because we will just spend them as if they are revenues. That is what we are doing now. You see, the surplus shows up as, in effect, net revenues, and it is spent. It is spent. It is disposed of.

Now, it isn't quite enough because we still have a little deficit to contend with, but that is what is going on.

Mr. KLEIN. Well, I think you should lay a nest egg for the future.

Senator HEINZ. Yes.

Dr. Samuelson.

Mr. SAMUELSON. Well, I——

Senator HEINZ. Could you pull your microphone forward just a little bit?

Mr. **Samuelson**. I don't wish to comment on the gimmickry of what you call the budget, the unified budget, those matters way you. It is like a family: some families' use little envelopes to do their saving, and others don't. I am not an expert on little envelopes, but I——

Senator **Heinz**. Some of us think that $3 trillion or $9 trillion is a lot of money.

Mr. **Samuelson**. No, no. I want to address the very important basic economic issue that you have mentioned, and I might even manage to generate a very slight disagreement with my learned colleague here.

I spoke of the devil's recipe for a high-consuming economy, and one of the ways of deciding what is high in the way of consuming is to calculate what your responsibilities are. With the baby boom generation looking ahead to its own retirement years without the supporting understructure of workers at that time—and I speak very responsibly on this matter because I perpetrated six of those baby boomers myself.

Senator **Heinz**. You did your best. [Laughter.]

Mr. **Samuelson**. My worst, yes.

A person as a private individual who is age 50 to 60 with inadequate capital formation in hand for an increasing long period of retirement is over-consuming, even when she or her are not spending more than their current income—because they are not making provision for what is clearly ahead. So it is with the American people.

I therefore think it is very important not to use the windfall of a nominal Social Security surplus to release yourself from the disciplines of not doing the over-public net spending.

Senator **Heinz**. May I just clarify that, Dr. Samuelson?

Mr. **Samuelson**. Yes.

Senator **Heinz**. One way I could interpret that is that we shouldn't use this surplus for the Government either to overspend or to undertax?

Mr. **Samuelson**. Yes, yes.

Senator **Heinz**. OK.

Mr. **Samuelson**. Exactly.

But I would not regard a decision on this social security matter—whether to include it in something called the unified budget or not—to be the same decision as to whether to include in the unified budget what we now discover to be the tremendous obligation of the Federal Government in connection with the savings and loan associations. Those horses left the stable some time ago, and recognizing this is a capital adjustment procedure. It obviously would make no sense to put in 1 year's budget what you have discovered in that particular year; nor would those expenditures ultimately have the same effect upon the flow of purchasing power and the real Main Street production economy that the differences between what you collect and spend on current account in the FISC does.

So I would pragmatically make those decisions as to what is included in the Budget or what is not included in economics terms on their merits.

However, there are people who are expert in gimmickry, and I think you should get such competent people to advise you there.

Senator HEINZ. Well, we are glad you noticed one of our more formidable skills. [Laughter.]

Thank you, Dr. Samuelson.

The CHAIRMAN. I want to proceed, with some attention to the clock, because there is this joint session, and I know members will need to go to that.

Let me now go to Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman.

I suppose, Professor Samuelson and Professor Klein, I come down a little bit on the side of the Chairman. We have had anecdotal information. We have seen some statistical information. We have had testimony from very learned people who indicate that we ought to be concerned.

And I must say that I am. If you look at the remarkable events that have occurred in Eastern Europe over the past few weeks, I think few if any of us could have foreseen those. It struck me, as an American, that that is a great triumph for American foreign policy, under both Democratic and Republican administrations in the post-World War II period.

We contained the advance of communism. George Kennan, it seems to me, has been vindicated. We, through an extraordinary generosity, rebuilt our adversaries as well as our allies, and their remarkable economic recovery you have attested to.

Indeed, all of those things that we hoped would occur—namely, the force of the free-market system—seems now to have lapped over the Iron Curtain, and tremendous change is occurring. And I look back on that, and I say, historians will write—perhaps economists will concur—that that has been a great victory for us as Americans.

Now, all of these things having come to pass—and I think they are very positive developments for us—it strikes me that because of our financial incapacity, we are now players on the sideline, that the opportunities that may exist as a result of those dynamic changes are not opportunities that American enterprise is going to be able to take advantage of. It is West Germany in particular, and the Western Europeans, the Japanese, the Pacific Rim.

If I am correct in that assumption, if you agree, is that not a further indication of how serious our problem is? Because it strikes me that this may be an opportunity that has been lost.

I would appreciate both of your comments on that observation.

Mr. SAMUELSON. Well, I want to agree. And I want to make a distinction.

The Kissingers of the world, the Metternichs, the people who design grand policy, must learn that you cannot do with 23 percent of world product what you can do with 40 percent of world product.

And so the description I gave you, as measured and objective as I could make it, of the decline in America's share of global output—and I do not go back to the 50 percent, because that was an artificial moment——

Senator BRYAN. No, I understand.

Mr. SAMUELSON [continuing]. Is a realistic fact of life. And we could not, if we re-ran history starting now, have as generous a Marshall Plan or MacArthur Occupation. We just would not have the resources.

Now, the distinction I would make is that not only do we not have the deadweight global output, the affluence, we also do not have the margin. We have no under-valued dollar with tremendous surpluses to recycle.

The reason that the Japanese can come in, in a very self-important way, into every IMF meeting, is that there is where the spare money is. Theirs is new money, recent money, not yet committed into consumption living, and so they are a much bigger player in the game, just as the OPEC countries were temporarily in their moment during the 1970's.

And so the way we run our domestic railroad that creates the utterly new, full-employment festering budget deficit, does feed directly into the chronic balance of payments deficit, and does definitely hamstrings any Secretary of State in the elbow room and the ability to do good things or bad.

Senator **Bryan**. But I guess you would not conclude from that, that that was an inevitable thing that had to occur? I would agree with you, that those extraordinary numbers in the aftermath of World War II, in terms of our global market share, those were aberrations as a consequence of the devastation of the war years. Nobody realistically ever could anticipate that that would continue.

But my sense is beyond that period of time, moving into the 1970's in particular. I mean, it seems to me that we have seen such an economic erosion that we have damaged ourselves in our ability to take advantage not maybe in a geopolitical sense, but in an economic sense, of what those opportunities are that may be unfolding in Eastern Europe.

It just seems to me that we are on the sidelines, that we are not really in there with the capital to do things.

Another piece of information was shared with us yesterday, that in terms of new capital based upon stock issues, the Japanese outraise us by a ratio of 12-to-1, that we have raised, I think, this year $10 billion; they have raised $120 billion. And the argument is—and maybe this is valid, maybe it is not; it strikes me that it is pretty persuasive—that they are going to be able to use that additional capital, in terms of new technology, new product development, and they are going to be even more fearsome as economic competitors in the global economy of the 1990's and the next century.

Professor Klein?

Mr. **Klein**. Well, let me say first, there are two issues. One is, our relative leadership, either in economics or in politics. And the second is our standard of well-being and prosperity.

We are not jeopardizing our prosperity. We are in a very great prosperity. We may have an ebb and flow, but we are not going to lose that right away.

However, we did not lose the leadership role right away, all at once. We lost it over 40 years. We certainly cannot regain 1945, but what we can do is improve our position, and that is what we should start rebuilding now. But it will not be done very quickly, and it will not be done under crisis conditions.

I want to say one more thing. The big lender to Poland with the Polish debt problem was Germany, and we should be thanking ourselves that we did not get involved. We did get involved in Latin America, and that is proving to be a very significant problem.

So if the big lending now, not only to Poland but to all of Eastern Europe, originates in Western Europe, that may be a good division of labor. [Laughter.]

And we should look at that situation very carefully.

Senator **Bryan**. That is cute.

The **Chairman**. Senator Gramm.

Senator **Gramm**. Mr. Chairman, thank you. And I want to thank our distinguished economists for being here today.

I would like to make a couple of points. I will try to be brief in my questions, and I want to try to get your response.

First of all, I reject the notion that being a debtor or being a creditor is the certain way either to prosperity or poverty. I would assert that you can tell relatively little about a nation's success by whether foreigners are investing in that country, or whether they are investing in other countries. You have to know a lot of other factors.

Second, all of these net debtor figures are based on acquisition cost, without appreciation, and tell us virtually nothing about the value of American investments abroad. In fact, when you take into account market value, it is even debatable whether America is yet a net debtor nation.

But I finally get to my first question. Our distinguished Chairman holds up a sign that plots foreign investment in the United States, and then he talks about debtor and creditor. Now, let me ask a question. If Formosa Plastics builds a new plant in Victoria, Texas, and spends $2.5 billion building that plant, is that a debt of the United States?

Mr. **Samuelson**. I believe, before you came into the room, I described in basic economic terms what the process of lending a recycled surplus meant to a country like South Korea when it was growing, and what it has been to the United States, and what it is like in the case of a country like Argentina.

And then I said, for the United States, we are closer to the South Korean pattern than we are to the Argentinean pattern. Because ours was not simply a borrowing that went 100 percent into higher living, consuming. It resulted in new trees of capital here, which would produce the fruits and nuts that could provide for its debt service in the future.

However, I was very careful to compare that process with a similar process where we did not have a fiscal deficit, where the calculated ex poste net savings of the United States was higher, and the same trees of capital were built in the United States in that same town in Texas that you described. But on the tree the tag of ownership was American investors. And then those fruits and nuts, which in the same way fructified the productivity of labor of American workers, created a flow of income which was part of the GNP of the United States.

So I do not think that any part of my argument rests upon some fallacy of how we ought to treat that.

Senator **Gramm**. But what I would like to add—obviously, I would rather an American—I would rather own it myself, actually. But are we poorer because citizens of a foreign country build plant and equipment in our country? Is that a debt of our country? Should we be discouraging it?

Now, let me first say, I agree with everything that has been said about the deficit. I have dedicated a lot of my energies here to try to deal with it. But aside from that, I want to go one step forward, because where a lot of these charts lead is not to deficit reduction, but to protectionism, to limits on foreign investment, to national economic planning to "make us more competitive." And that is what I want to get to.

Should we have a policy that limits foreign investment in the United States, when the investment is building plant and equipment? Is that really a debt? Should we think of it as a debt?

Mr. **Samuelson**. We will be poorer in 1999, because we did less saving in 1989. The "we" that I am speaking of now is the American people who constitute the gross domestic product of the American people.

On the other hand, if we did not get the recycled surpluses—suppose that were the case—then we would not have the trees at all. The crowding out, which was so scorned by Treasury memos in the 1980's, as saying that there is no evidence for it, is a reality. Without tapping foreigners' savings, we would not have those trees planted.

That has been the only way we have been able to have a normal ratio of gross investment to gross national product in the 1980's, given our domestic propensities to save, family, corporate, public, because of the recycling.

So I would rather have the recycling than not have it. But I would still prefer that we not be in a position where there are such surpluses that need to be recycled.

Senator **Gramm**. But let me be sure. Let me state it, if I can, trying to just be precise, to be sure I understand. Anything we can do that promotes thrift, that reduces the deficit, that frees capital to go into the private sector, that encourages savings, is great.

The question is, all of that given, are we richer or poorer when foreigners invest in the American economy?

Mr. **Klein**. We are not poorer.

Senator **Gramm**. We are not poorer.

Mr. **Samuelson**. I think it is a benefit to the American economy.

Senator **Gramm**. You would oppose efforts to limit foreign capital investment?

Mr. **Klein**. It is a two-way street.

Mr. **Samuelson**. Well, provided that the 20th century rules of conduct for a foreign investor apply, such as we obey when we go abroad are obeyed here, and provided there is no collusive taking over of basic security and defense industries, no red-lining of minority workers, provided all the codes of good conduct are obeyed—then I believe in the virtue for us of having that foreign investment.

Senator **Gramm**. Dr. Klein, did you want to respond to that?

Mr. **Klein**. Well, we are not poorer. You know, how did Mr. Wong of Formosa Plastics acquire the capital to make the investment? It is through earning dollars or hard currency in world markets. And so we are getting back to the deficit problem.

But his act of investment in the United States is not anything that should bother us, particularly in that industry. But it does mean that what we really want is to get the current account in balance, and we will then have some foreign investment in this country, and some Americans will be investing abroad as we always have.

Now, I want to mention one other technical point that has been raised by our joint colleague, Professor Eisner of Northwestern, that we have not valued the assets properly, and the assets are carried on the international books at original cost, and they have appreciated. So just taking the present figures does not really tell the story about more wealth or less wealth.

But there is one other side to consider. We have to finance the deficits. So if we just look at the deficits for which we need to issue securities or get financing, that has an impact on the money market. And it is the money market impact, in terms of interest rates and dollar rates, that feeds back on the performance of the economy that we should be concerned with.

So we should be concerned with our deficit problem, but we should not be concerned that Mr. Wong is building a new plant in this country.

Mr. **Samuelson**. Could I just also speak to that? It is a legitimate point that, when people gave the date at which we became this net debtor nation, they were using asset values not completely brought up to date and revalued at their current value. Dr Charles Wolfe of the Rand Corporation has made that point.

That simply changes the date on the chart at which the most correct estimate of our net indebtedness crosses into being positive. And the situation will get worse, because even projecting improvements in our competitiveness, nobody is projecting that we go from large negative payments deficits to balanced numbers.

And so it is going to get worse. Now, it is not my function to exaggerate these phenomena, but they do not go away.

Senator **Gramm**. Thank you.

The **Chairman**. I want to go to Senator Shelby right now. Some time, at another time, we will have a discussion about whether it is better to be an owner or a renter, and if there is a difference in those two things, because it seems to me that that lies at the heart of this thing.

Senator **Shelby**. Mr. Chairman, I have an opening statement. I was at the Armed Services Committee hearing. I would like it to be made part of the record.

The **Chairman**. We will make that a part of the record.

Senator **Shelby**. I have one question, a statement first.

Americans now save less, they obviously learn less, according to a lot of statistics. And now, due to foreign ownership, I believe in a lot of instances they own less.

Now, can you tell us whether or not, Dr. Samuelson and Dr. Klein, you believe the fast-increasing ownership of our assets is directly related to our budget and trade deficits?

Mr. **Samuelson**. I believe that the increasing percentage of ownership by foreigners in assets located in the continental and island United States has gone up——

Senator **Shelby**. Yes, sir.

Mr. SAMUELSON [continuing]. Primarily because of the differences in private saving rates. But our budget deficit has been a contributor to our low overall saving rate. And so it deserves a significant share of our concern.

It could not happen, however, without the balance of payments deficit. It is no longer normal for the United States to have a surplus in our balance of payments, if we are moving into a new low-saving epoch, while our main trade competitors are still in the high-saving epoch.

Senator SHELBY. Dr. Klein.

Mr. KLEIN. Well, I want to make one technical point about saving. At the personal level, the household level, it is definitely low in the United States, and that definitely contributes to the influx of foreign capital, in many ways. Our American investors would be buying up assets, rather than foreigners, if they saved more.

But business saving is not all that bad in the United States, which is another important part, and primarily because of our treatment of depreciation. We give very generous depreciation allowances, and that money is kept within the company.

Senator SHELBY. Would you call that a hidden savings, maybe?

Mr. KLEIN. Oh, yes, definitely.

Senator SHELBY. It is a hidden savings that maybe a lot of attribution is not made or accounted for it.

Mr. KLEIN. It is available for capital formation.

Senator SHELBY. Sure.

Mr. KLEIN. Yes.

Now, it is no accident in the chart that I distributed that the current account deficit is of the order of magnitude of the budget deficit. It is really an expression of the fact that foreigners are buying our Treasury securities and financing our debt, on balance. Or, it is also the case that, if we have a current account deficit, that we must cover that with a capital inflow, and that capital inflow ends up in ownership of many American assets.

So if you want to move toward an older situation, when we did not have this degree of foreign ownership, then we should simply save more and do some of our own investing, and we should have less of a public drain on the funds available—a Federal public drain on the funds available.

Senator SHELBY. Dr. Samuelson, I believe you—and I will try to be brief here—alluded to—I did not hear your testimony earlier—the fact, and I will just paraphrase it, that it is not where the money comes from, but it is what you do with the money.

Is that a fair statement? In other words, if we were using a lot of money from Germany and Japan for capital investment in this country that is going to produce fruits down the road, that is not altogether so bad in itself; is that correct?

Mr. SAMUELSON. Right.

Senator SHELBY. Is that the gist of your statement?

Mr. SAMUELSON. Well, that is part of my statement.

Senator SHELBY. Part of it.

Mr. SAMUELSON. But you have given me the opportunity to say something that I would like to say, that has not been said here.

Senator SHELBY. Yes, sir.

Mr. **Samuelson**. Economics is like a chess game. It is not the question of getting the policy to get the best first move, because there is always another move. And now I come to my point. Suppose we were to become competitive overnight, with no change in budget behavior or in personal saving propensity, so that solely by Schumpeterian-MIT wisdom America became competitive overnight, and thereby did wipe out our balance of payments deficit.

That first chess move would definitely on the second move crowd out domestic investment to a tremendous degree. We are at a fully employed economy. We would newly be providing resources for export purposes, to wipe out our trade deficit. That would come right out of, given our saving propensities being unchanged, would come right out of capital formation. And there would end up being fewer trees here in 1999 owned by anybody than would otherwise be the case; and worker productivity, to the degree that it depends upon having good capital equipment here in America to work with, would be that much the lower in 1999. Real wages in America would be that much the lower.

Because our basic low-saving syndrome itself has such important consequences, it is all the more important not to put public deficits on top of it.

Senator **Shelby**. Mr. Chairman, we need to get these two distinguished economists before the Banking Committee at regular intervals, I believe.

The **Chairman**. I agree with that, Senator Shelby. And I am distressed that after we scheduled this hearing, that the joint session with Lech Walesa came along, because I was——

Mr. **Samuelson**. You should be happy.

The **Chairman**. Well, we are very happy. But we are not happy that we did not have more time with you now.

Have you concluded, Senator Shelby?

Senator **Shelby**. Thank you.

The **Chairman**. Gentlemen, I want to continue a bit, if that is agreeable with the two of you.

I think this is a profoundly important discussion, and we are really sort of on the front edges of it. And we have gotten into it to a degree, but not yet to the degree I think we need to. And I would like to set the stage for a little bit of further discussion.

In this town today, in terms of the major economic and financial policy thinkers in Government and around Government, there are sort of two quite different views that are sort of playing off each other.

One view is to the effect that things are fine. The surface data looks good, nobody sees an imminent sort of plane crash in the immediate future. And the bottom line of that is expressed one of two ways: "If it ain't broke, don't fix it," or "Don't worry, be happy." I mean, that is sort of the popularized, sing-song way that point of view gets described.

That becomes the basis for saying we do not need any major set of changes, which means we do not even need a serious discussion because, perforce, we are doing fine.

There is another point of view, and it would be one that I obviously share from what I have said, but that I think a growing number of people share. And I am hearing it from more and more people that are coming through the door. I am talking about serious business players in the international market, lots and lots of people who have good information, good insight, very thoughtful, practical people.

They are saying we have got some real problems, that the world has changed, that the mix of our fiscal and economic policies is really out of sync with what they need to be. In very important ways, we are falling behind, because we have got this miserably low savings rate, we have got this miserably low capital investment rate. We are consuming up here at a very high level; we are producing at a level below that.

We are adding up debt in every direction. And most of the foreign money that is coming in is not coming in to build plastics plants in Texas or Mazda plants in Michigan—and we are happy to get them when they come—most of the foreign money coming in is in the form of debt, and is being used on current consumption, not on capital investment, but on current consumption and in financial transactions. And the numbers are—we have had expert testimony that that effect.

And so there is a large flow of recycled, former U.S. dollars that are now in the possession of other foreign players that are coming back into the United States. But really a rather modest part is going into the kind of long-term investment in this country that we need to be doing for ourselves, and that any leading country needs to be doing on a large scale in a rapidly-advancing, technological world.

I see even a more subtle aspect of that, and I will just say this as an aside, because I do not want to get off my main point here. And that is that I see more and more of that activity in what I would call the "worker bee" classification of activity—in other words, the very sophisticated, the highest-level technology activity.

I see it in the automobile industry, which is centered in my state; that the most sophisticated aspects of the part of producing an automobile—the engine, the electronic componentry, and so forth—is by and large still produced overseas. Those assembly parts come in here, and the assembly operation is done here. There is some part of domestic content that goes into the car, but certainly far less than 100 percent. In most cases, far less than 75 percent, in most cases far less than 50 percent.

And not that that is not useful on the margin to have; as compared to not having it at all. But if one assumes that somehow or another we are having state-of-the-art, full-range activity going on in this country with those foreign investment activities, for the most part, I find that not to be the case. There may be some instances where that is the case.

I also find that a lot of the capital investment money is coming in and picking off promising companies. Now, you make the point about looking at strategic implications of defense, and maybe banking, and maybe transportation facilities, and things of that kind. And so that creates a different type of debate.

But as I watch this recycling go on, I must say I am not drawing a great degree of comfort from it, that the tree planning, the capital tree planning is really anywhere near what we need, even if it is going to be financed from abroad. This leaves aside the question of who gets the fruits and nuts. Because I think there is a big difference between owning the building and being a renter in the building. I think there is a huge difference there.

Having said all that, that is sort of on the one side of the people who say, "If it ain't broke, don't fix it," and "Don't worry, be happy."

On the other side are people who say, given all of these very severe trend-line problems in terms of low savings rate, low capital investment, low relative productivity, in terms of what the leading nations are cranking out these days, that we are working ourselves into a very severe structural problem in this new world economy.

I would assert to you that when I studied economics at the University of Michigan, or down the road at the Harvard Business School, the world looked different than it looks today. I mean, it was a different economic global economy than it is today.

The Japanese do not play by the same rules that we do. I do not say that disrespectfully to them. They have found a strategy that works very well for them, and they are cranking out very good results from it, as are others who use different examples.

But I come around the fact that it seems to me that the United States now must have a serious economic debate with itself. That the people of this country, main street—and I agree with you, Professor Samuelson; I think what goes on here is really in very large measure a reflection of what main street is thinking. I do not think there is any great disconnect inside the beltway here.

We need to have a serious economic debate with ourselves as a people, and we need to put our finger on these problem areas where we are falling short of what we need to do. You have really hammered it home on the fiscal deficit. I agree 100 percent. The savings rates, the other issues I think that relate to this—we have got a huge educational deficit in terms of our performance levels there. And we have not even talked about that today; but when the high school drop-out rate in America is 26 percent and it is 2 percent in Japan, and we do not see that as an urgent problem, I think we ought to be shipped off to Saint Elizabeth's.

I mean, that is an enormous defect rate, failure rate if you will, in the education system. Any manufacturing plant that had a 26 percent defect rate would be out of the game in 2 weeks, you know. And this is the most important thing we produce, and that is the value-added understanding and capacity of the people of the country.

I mean, you people have devoted our life to teaching and education, and it is the centerpiece in terms of what we are going to do in the future. Miserable performance statistics there.

We cannot even get a debate started right now in a serious way on these issues, partly because a lot of people say, well, we are clicking along, things are fine, growth is at 2, 2½ percent, inflation has not gone out of sight. Yes, we have got high real interest rates relative to others, but we can live with it. And we keep putting everything on a credit card.

I mean, we have just put the recovery for the last 10 years on a credit card. I mean, we are going to have to pay for that later. And we are doing more of the same.

Somehow, it seems to me that it is time for thoughtful people to say, "Look, we have to do a disconnect here. We have got to stop behaving with this combination of policy patterns, and recognize that if we do that it takes us to a bad future."

I do not know quite when. I do not know whether it is 2 years, or 5 years, or 10 years, and it really is quite irrelevant. Because if you are on trend lines that are not self-correcting in and of themselves with good results, but that in fact take you to what appear to be bad results down the line, then it seems to me that you have to get off those trend lines.

Any intelligent person ought to say to themselves, "I do not want to get to that kind of an end-game situation. I want to get to a much more positive, constructive end-game situation. So I need to do some things today. I need to straighten up, I need to discipline myself in a certain way, I need to change some of my behavior patterns," and so forth.

And if you are going to have even that kind of a discussion, then you get into very interesting process questions: Who talks to whom? If you get people in the room, who comes in? Does the President call you in, or does he call in another group, or do corporate leaders get together with academic and political leaders? I mean, how do you even capture the country in some manageable work group to start to reflect about these things?

Right now, this is about as close as we can get. At least we are trying to do something to get this debate out in the open in a serious way.

You know, I guess what I am wondering is—everything that I can see and get my hands on that seems to make any sense tells me that the "Don't worry, be happy" theory is absolutely wrong for the country, and is about as dangerous as it can be, given these underlying deficiencies in terms of the things that really will build the economy for the future.

I have the feeling that our kids in 10 or 15 years are going to be asking all of us—your six, and my four, and anybody else who has any—when they get out in about 1998 or the year 2000, and they are looking at being in a much more constricted situation, with a huge load of debt to service, most of it for consumption and not capital investment—I think they are going to say to us, "What were you jokers doing back in 1989?" I mean, "Did you do anything about it? Did you try to focus the issue? Did you ring the alarm bells? Did you try to force a change?"

And I do not say that to you; I say it to myself. Because I am in a direct policy position. But those of us who are, it seems to me have got some obligation. Unless there is a very compelling case that says, look, do not worry, you know, take the native impulse and suppress it because things are fine and there is a certain sort of ebb and flow to these things, and we may be in a down trough here, but it will work out, and we will get 10 or 15 years out down the road and things will be fine.

Mr. **Samuelson**. Well, I am with you. If it were not broken, we should not fix it. But the people who use that simple slogan would not know what "broken" meant. When people suffer from hypertension, they feel great, but they are on a collision course with hardened arteries, strokes, heart attacks.

The present situation is not, looking at the prudent future, not something to feel complacent about. It is something to be concerned about. And I have tried to measure out some of the economic concerns that I see in the picture.

The **Chairman**. Mr. Klein.

Mr. **Klein**. Well, if you say things are going along all right—and there is that school—they are——

The **Chairman**. Mr. Samuelson, let me do this. I know you have an 11:30 flight, and you should leave right now in order to make that flight. So let me thank you with just great appreciation. I am an enormous fan and admirer of yours and of Mr. Klein's. So I just want to thank you so much for coming today.

Mr. **Samuelson**. Thank you very much.

[Whereupon, Paul A. Samuelson left the hearing room.]

Mr. **Klein**. The immediate future is already in a slowing down pattern—could be a recession. I am not saying one way or the other today for our discussion. But it is not going to be—it does not really look like—the "Great Crash of 1990."

On the other hand, if you want to look ahead as far as the year 2000, as best we can, or in that area, then indeed we are building up for trouble. The reason for that is that not only do these debt figures or the deficit figures grow, but they grow in relation to our production; say corporate debt in relation to cash flow, or corporate debt in relation to GNP originating in the corporate sector, or national debt and GNP.

Those ratios are growing. And what we should really be aiming for is to stabilize those ratios. There is a kind of rule of thumb that, if the growth of GNP is faster than the rate of interest, then the ratio of debt to GNP will probably stabilize. It is a little more complicated than that, but that is the rule.

This has been applied to international debt. If a country's exports grow faster than the rate of interest paid on those debts, then the debt-to-export ratio will tend to stabilize.

So we should be concerned that these ratios are growing. Some people would argue that they are growing along a trend line that has been established, so we do not worry, they are only trends. But these trends cannot go forever. That is one problem.

And second, when there are cyclical corrections, as there will be, then it becomes increasingly difficult to continue the servicing of these debts.

So really, my position is that we have not yet come to the breaking point. There is trouble ahead, exactly as you stated, and we should be setting forces in motion now. This is the time to do something about it.

The tax reform of 1986 did not do anything about the saving rate, did not really elevate it, and did not pay attention to the macroeconomy. It was microeconomic-inspired——

The **Chairman**. Right.

Mr. **Klein** [continuing]. To have horizontal equity. And they neglected the macroeconomic impacts. So we can go back and reconsider that.

The **Chairman**. Right.

Mr. **Klein**. And we must address the deficit, the Federal budget deficit, right away. Those are things that still can be done.

The CHAIRMAN. Right.

Mr. KLEIN. Now, people who would say, "Do not intervene," might argue that there is an adjustment process taking place in money markets, foreign exchange markets; which is true, but it is too slow and too unreliable. That is why the foreign trade deficit, after 4 years (more than 4 years, almost 5 years) of dollar depreciation has not been corrected fully. It has been partially corrected. There is something in motion.

So it is very slow, and we must do something to improve the timing of the adjustment process.

The CHAIRMAN. Well, that is a very helpful comment. And I have come to the same conclusion about the last tax cut. I think you describe it very well, in terms of the horizontal equity issue.

But if you look at the macroeconomic effect—and we have been analyzing that just recently—we tip the axis of the tax code toward consumers and against capital formation, and business investment, and the things that would enhance productivity and start to close these other international trading gaps.

Mr. KLEIN. Right.

The CHAIRMAN. And in a sense, we put exactly the wrong tilt in to try to deal with these other problems that you cite.

Mr. KLEIN. Exactly.

The CHAIRMAN. And now, we are going to be faced with the awkwardness. Because you know, every time we change the tax code, everybody says, "Now, leave it alone for a while, do not tamper with it." But I think that, while we may have solved some problems, that we unwittingly may have added to other problems that are in fact even far more severe in the context in which we are talking today.

I take it that that is also now your view?

Mr. KLEIN. That would be my view, yes.

The CHAIRMAN. Just to take that one more step, we have done an analysis of that, to take it down to another level of detail, in terms of how it would affect corporate financing behavior as it looks at the difference and the attractiveness of debt financing versus equity financing.

By running some samples, we have come to a conclusion, that that tax package, because of multiple tax changes that were not interconnected in the analysis, now in fact has an aggregate effect of opening up a very wide differential between the advantage of corporate debt financing as opposed to equity financing. And it moves way off the historic norms, and it creates a huge new I think unintended incentive to reach for debt financing as opposed to equity financing. And so it accelerates that whole move toward the over-leveraging and the debt pile-up problem that we all see in every direction.

It is a very perverse effect. And it is hard to track it through and get it assembled in a way that you can sort of put it out on the table and have the kind of revelation power that it needs to have for people to suddenly understand that we did something that we did not really intend to do, and that is beginning to have a very substantial incremental effect on just how the capital structure process is working.

Just a couple of other things, and then we will finish for this morning.

It seems to me that the rest of the world is not going to wait for the United States. We had testimony yesterday that an under-Cabinet officer from the U.S. Commerce Department just went over to Japan and, in official discussions with Japanese officials apparently—it is reported that they said to the Japanese that they would like the Japanese to slow down their capital investment rate, these huge differentials that we spoke about earlier, because it was just creating too much difficulty, and we are having such a hard time cranking ourselves up to a higher level, which requires discipline and changes in patterns and more savings and so forth.

And so we had actually—the policy manifestation had become one where our officials were asking them basically to do less, so that it would not aggravate the problem. It was reported that the Japanese were—you know, I mean, just taken aback by that kind of a suggestion, and saw that as a further sign of the United States lacking the will and the seriousness of purpose to do the things internally that we need to do.

And so, they are laughing at us. I mean, they are laughing at us as they continue to be in a very strong comparative economic position. Their bilateral trade surplus will still be in the range of $50 billion this year, give-or-take. And it is extraordinary, when you look at it year by year over the last 10 years, in terms of that bilateral deficit.

I have the sense that the United States is slowly putting itself into a kind of straitjacket, because of this growth of debt owed to foreigners, the fact that we rely so much in our current consumption on borrowing from others, and we are just putting the bills off into the future—that when we finally wake up, we will have squandered a lot of our options. And what will be available to us at that time will be far more difficult, and far more onerous, and far less happy to have to face as a country.

And if that is so, then every day we wait, we make the problems harder to solve. In a sense, waiting is almost like a disease, because the longer you wait the more unattractive it is to face reality. So you are inclined to wait even longer.

And so you get into a situation where you can work yourself into a hole that you may not be able to climb out of without tremendous problems.

I will just say one other thing about it. You mentioned—and I appreciate the fact that you did—about things that one starts to see in the society as a whole, whether it is homeless people, you mentioned the Eastern Seaboard. Washington is a classic city today for having a large number of homeless people.

We have all these hot air grates that are on the sidewalks because the heating pipes run between the government buildings. And we now have more homeless people than we have hot air grates. In the wintertime, on the coldest nights, there are literally people lined up to get on the hot air grates, and there are not enough hot air grates to go around.

That is just one manifestation. The high school drop-out rates would be another. The drug problems are another. The homicide rates here in Washington. I do not mean to make a one-for-one relationship, but you start to see the manifestations of underclass difficulties and other social fall-out of an economic system that is not functioning as efficiently as it should and as well as it should.

Mr. KLEIN. It is not spreading the prosperity around properly.

The CHAIRMAN. But as there is less to spread around, and as more of our current consumption was financed with borrowing, which is putting it on a credit card to be paid later, you in a sense are stealing from the future. You are stealing from your capacity in the future.

When you finally decide you want to face up to those problems, it becomes far more difficult to do, because you have got foreign creditors banging on the door and they want what you owe them first. So that has to come off the top.

We also have this terrible dilemma. You know, if you really do the honest accounting on the federal budget deficit now, it is about $250 billion or higher. That is essentially what we think of as full employment. God forbid, we should get a turn-down——

Mr. KLEIN. It will be worse then.

The CHAIRMAN. Probably by $100 billion.

Mr. KLEIN. Yes.

The CHAIRMAN. It does not take much in the way of a rise in unemployment, both in terms of transfer payments out by the government for unemployment, and food stamps and so forth, and also the loss of revenue. I mean, you can add $100 billion to the deficit in a very short period of time, if you get into a down business cycle.

The thing that is so astonishing to me is that normally when we are at full employment that is the time when we put a little fat on our bones so that we can ride out the lean years. We have now completely turned that upside-down.

We now behave in such a way that we not only do not put away a nest egg in good times, but we are accruing larger and larger debts in the good times, so that when the bad times come, we are going to find ourselves in a far, far more difficult position to deal with it.

The thing that is astonishing to me is, I do not know why we cannot get more of a debate going. I do not know why there is not a greater sense of urgency.

Your chart here today, if I just had to see one piece of factual data to cause me to scratch my head and say, "Is something seriously amiss"——

Mr. KLEIN. There is something wrong in that.

The CHAIRMAN. Yes. There is something radically wrong in that. And you sort of look at it, and it seems to me that our thoughtful obligation is then to try to figure out what are the 10, 20, 50, 1,000 things that in combination are causing this to happen.

But I do not see how any major nation in the world today that wants to continue to be in a position of pre-eminence in the future, all the way from living standard to role and ability to act on the international level, can take these kinds of incredible changes and not come to terms with them and figure out how to put a strategy together that gets us back to a sensible kind of equilibrium and balance in terms of how our economic system is working in the world economy.

Mr. KLEIN. Well, as early as 1981 was the time to do something about that. It is not too late now, but it is certainly never too early to start. And that is why the process should begin right away.

But it should be planned for something that will be effective, noticeably effective, within two or three years, and hopefully that would be completely effective by five or ten years.

The CHAIRMAN. Well, we hope to develop such a set of either targets, adjustment targets in terms of performance by category, various savings rates and capital investment rates and so forth——

Mr. KLEIN. Right.

The CHAIRMAN [continuing]. And to look at those things that would do this so that they start to bite in, and so that you start to see results within that kind of timeframe that you cite. That will really be a central purpose of this committee.

It is not easy to do, especially when there is so much heft on the other side of the argument that says, you know, "Don't worry, be happy." I mean, that obviously makes it more difficult to frame a serious discussion that may involve, will involve, does involve taking some unpleasant medicine.

Thank you very much for coming today. We are very grateful.

Mr. KLEIN. Thank you. A pleasure.

The CHAIRMAN. The committee stands in recess.

[Whereupon, at 11:12 a.m., the committee hearing was adjourned.]

[Response to written questions follows:]

THE CARLYLE GROUP
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August 22, 1989

Honorable Donald W. Riegle, Jr.
Chairman
Senate Committee on Banking, Housing and
Urban Affairs
Washington, D.C. 20510-6075

Dear Mr. Chairman:

I am enclosing answers to the questions presented to me in your letter of August 1. I should note for the record that I have received assistance from DoD in providing these answers.

Sincerely,

Frank Carlucci

Frank C. Carlucci
Vice Chairman

FCC:clw
Enclosure

Q.1. In the context of the debate over whether to extend the scope of the Defense Production Act (DPA) beyond its present authorities, to your knowledge have there been instances when the Defense Production Act, in conjunction with other appropriations power, was not broad enough to include a key defense preparedness industry? In other words, when have key industries been lost? What were those industries? And what were the situations surrounding the losses?

1. DPA Title III authorities have been applied primarily to expand mineral, metal and other basic materials industries. In the 1950's, when these authorities were used extensively to expand materials production capacity, they were complemented by accelerated tax depreciation provisions and a machine tool pool order program to expand production capacity primarily in durable goods industries. The Title III authorities fell into disuse in the 1960's and have been resurrected only recently. Use of Title III authorities is currently limited by low dollar ceilings on the projects requiring specific prior congressional authorization and by low funding levels.

With regard to the question concerning key industries being lost, I would rephrase the question to address key industries being weakened. Two prominent examples of these are the semiconductor and bearings industries, but there are many others. Simply stated, rising import shares of the U.S. market in key subtier industries has weakened the preparedness of the U.S. production base. A number of reasons for the declining competitiveness of U.S. producers were cited in my testimony.

Q.2. Mr. Inman testified about the benefits of broadening the anti-trust immunities in the DPA and suggested Congress make it easier for industry to join in research and development (and possibly manufacturing and marketing) consortiums. You testified that protectionism and complacency contributed to the competitive decline of U.S. industries in the world economy. What impact do you think Mr. Inman's suggestion would have on U.S. competitiveness in the world economy?

2. The reality of the international marketplace has changed the nature of anti-trust behavior and competition. Pooling of several U.S. companies resources to increase R&D efficiency and effectiveness may ensure a more competitive marketplace in cases where individual U.S. companies would lack sufficient resources to meet the competition from abroad alone.

Q.3. Mr. Costello testified about the importance of broad purpose section, detailing congressional purposes for the DPA. There seems to be a problem with "reducing defense production lead times and bottlenecks." This appears to me to be an agency and industry problem, the solution of which lies with increased efficiency. How would this goal be related to the Defense Production Act? Another suggested change in the purpose section would express concern about "maximized response" to "early warning indicators." Do you think that is necessary in light of the overall goals of the Act?

3. Title I authorities are used to reduce lead times and bottlenecks by requiring priority treatment of orders for critical defense purposes and by allocating short-supply materials for these same purposes. Title III authorities are used to reduce bottlenecks by expanding production capacity in bottleneck areas.

"Maximized response" to "early warning indicators" is needed to increase industrial preparedness in a timely fashion. It takes time to surge or mobilize production. The concept of Graduated Mobilization Response is to increase industrial preparedness in a manner that corresponds to any increased risk to our national security. The Defense Production Act is a cornerstone of our industrial preparedness program and Graduated Mobilization Response is a (new) key element of this program. Therefore, it is appropriate to state this concept as DPA goal.

Q.4. In your testimony you make two suggestions of measures to ensure a competitive U.S. industrial base. The second one was adopting long-term funding in defense programs. Please elaborate on the reasons for long term funding and specifically address whether such a funding goal is properly within the purview of the DPA.

4. Long-term funding of defense programs increases efficiency by permitting investment decisions to be optimized over a larger production buy. For example, assured long-term funding might justify a higher investment in modernized facilities and equipment and in worker training because of the larger guaranteed sales base for amortizing the cost of such investment. Similarly, long-term funding can also contribute to more program stability and eliminate the costs associated with constantly changing production rates. The benefits of long-term funding are reflected in the Defense Production Act in the purchase and purchase commitment authorities under Title III. In essence, these authorities are used to stimulate private investment in needed production capacity by providing a guaranteed market over a number of years.

Q.5. You mention a number of reasons why U.S. industry has experienced competitive decline, and you suggest as one solution encouraging more rapid adoption of new concepts in the manufacturing process, including more adaptive management policies. What do you see as Congress's role in effecting that change and in effecting other changes, such as easing procurement regulations?

5. I see Congress playing a key role in the revitalization of our industrial base. In my judgment, that base has eroded for the following reasons:

a. Funding instability as described in my answer to Question No. 4.

b. Overemphasis on price competition at the expense of quality. U.S. industry in general has been late in developing TQM programs. They are now being extensively implemented. DoD has supported such a program, but this has not been fully reflected in congressional legislation. I think it is vital that Congress get behind this effort.

c. The effort to squeeze every last dollar out of industry, which has caused industry sources of capital to dry up. P/E ratios are at a 25-year low. I know of no investment banker who recommends defense investment to his or her clients. Progress payments have been decreased, reduced limits have been put on profits and inappropriate contract instruments have been applied in an effort to get industry to share a disproportionate share of the risk (e.g., firm fixed price developmental contracts). As a result, according to a recent CSI study, approximately 150,000 companies have moved out of the defense contracting business between 1982 and 1987.

d. Increasing congressional intervention in the process. This has led contractors to focus their contacts on the Hill with a concomitant breakdown in the authority of the program manager. To oversimplify, a contractor can frequently get a better return on his money by investing in lobbyists and consultants rather than investing in long-term productivity enhancements.

e. The hostility with which the Congress, press, and DoD have treated the industrial base. Investigation and inspection have tended to take on a punitive tone and "contractor bashing" has become politically popular. While it is important to exercise oversight of the contract or community, we need to recognize that this community is a vital part of our national security apparatus. As long as we keep that base in private hands, it will respond like any industry to risk reward stimuli. Right now, risk reward ratios are out of line with other industries.

WESTMARK

August 24, 1989

Mr. Edward M. Malan
Editor
Committee on Banking, Housing and Urban Affairs
Washington, D.C. 20510-6075

Dear Mr. Malan:

Enclosed are responses to Senator Garn's questions relating to reauthorization of the Defense Production Act. The questions were included in Senator Riegle's letter of August 1.

Q.1. In the context of the debate over whether to extend the scope of the Defense Production Act (DPA) beyond its present authorities, to your knowledge have there been instances when the DPA, in conjunction with other appropriations power, was not broad enough to include a key defense preparedness industry? In other words, when have key industries been lost? What were those industries? And what were the situations surrounding the losses?

Q1: I am not aware of any key industry which has been lost because the scope of the Defense Production Act was too limited. This is not to say that the U.S. has not lost key industries. For example, the deterioration of the semiconductor industry and the supercomputer industry are two examples of critically important problems. Perhaps a more relevant question is whether provisions of the Defense Production Act could have been employed more aggressively to slow or stop this deterioration before the situation reached such a critical stage.

Q.2. You suggest broadening the anti-trust immunities in the DPA, which could be used to allow industry to more easily join in research and development consortiums. It has also been suggested that these consortiums allow manufacturing and marketing. What, as you see it, would be the effect on the chances of a small business in the United States to secure defense related government contracts? In light of Mr. Carlucci's testimony what do you think would be the effect on industry competitiveness as a whole?

Q2: I support expanding the National Cooperative Research Act to include manufacturing. I am less certain about including marketing in the expanded act

Small businesses have much to gain from cooperative research and manufacturing ventures. The capital investment required to modernize manufacturing facilities, as well as the process technology required, may not be available to small companies acting alone, due either to cost or complexity. Small business manufacturing consortia will provide a mechanism to address these problems.

In a larger sense, U.S. companies need every available tool to compete in today's markets. A particular problem is the ability of foreign competitors to assemble vertically integrated ventures aimed at innovation and production of particular technologies. Expansion of the National Cooperative Research Act would reduce the reluctance of U.S. companies to initiate similar arrangements.

Q.3. You testified about statistics, contained in a report issued by the Center for Strategic and International Studies (CSIS), showing that over 80,000 suppliers left the defense marketplace during the 1982-1987 period despite the increase in dollars for defense procurement. Suppliers are leaving the defense marketplace for more profitable endeavors, as was concluded by CSIS, and your testimony further indicates that more money for defense procurement will not solve the problem. One suggested DPA amendment is to nearly double the amount available in the fund for DPA projects. What is your reaction to this?

Q3: Increased incentives can be useful. However, such incentives are not panacea. Without major improvements in acquisition and project management, permitting contractors to adequately profit from their activities, the erosion of the defense industrial base will continue.

Q.4. In your testimony, you state that only the United States "faces the dual challenge of maintaining its preeminent economic position and supporting significant military obligations." You say we must not be forced to make a choice between the two. In your opinion is it fair to ask an industry to both compete with and bear the burden for defending their foreign competition?

Q4: Clearly, we must continue our efforts to increase our allies' share of the defense burden. We must not, however, take actions detrimental to our national military security as a way of punishing our allies for their anti-competitive practices.

We can, however, demand that our allies provide equal access to their markets. For example, extending reciprocity in defense MOU's to include access to government non-defense procurement could improve markets for U.S. corporations. More generally, improving the coordination of our national defense and trade policies should be a priority.

* * * * *

I appreciate the opportunity to provide these additional comments. Please feel free to contact my office if further information is necessary.

Sincerely,

B. R. Inman
Chairman and Chief Executive Officer

Policy Research in the Public Interest

HUDSON
I·N·S·T·I·T·U·T·E

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October 10, 1989

Mr. Ed Malan
United States Senate
Committee on Banking, Housing, and
 Urban Affairs
Washington, DC 20510-6075

Dear Mr. Malan,

In response to Senator Garn's questions, I am submitting the following comments. My apologies for the time delay, but the questions were not received until 4 October.

Q.1. Mr. Inman testified about the benefits of broadening the anti-trust immunities in the Defense Production Act (DPA) making it easier for industry to join in research and development (and possibly manufacturing and marketing) consortiums. What impact do you think Mr. Inman's suggestion would have on U.S. competitiveness in the world economy?

1. The broadening of anti-trust immunities in the Defense Production Act making it easier for companies to form consortiums should be supported aggressively. When testifying, I supported Admiral Inman's position and went further and suggested that consideration should also be necessary in the near future to allow companies to form consortiums to manufacture and sell products in certain special cases. I referred to the new memory consortium now being formed. The purpose will be to manufacture and sell high-density, high-quality memories here in the U.S. The capital investments in some industries are so high that pooling of resources and market sharing will be the only way U.S. companies will be able to compete in the world market. Care must be taken to maintain effective controls, and industry must be required to evidence self-governance to insure compliance with current anti-trust laws and any waivers allowed.

Q.2. You testified about the importance of the section detailing congressional purposes for the Defense Production Act (DPA) "reducing defense production lead times and bottlenecks." This appears to me to be an agency and industry problem, the solution of which lies with increased efficiency. How would this goal be related to the Defense Production Act? Another suggested change in the purpose section would express concern about "maximized response" to "early warning indicators." Do you think that is necessary in light of the overall goals of the Act?

2. The reference to reducing defense production lead times and bottlenecks reflects, primarily, agency and industry problems. However, the new DPA could be used to focus agency and industry attention to the bottlenecks that are largely regulatory and administrative in nature, and not statutory, as many would like to suggest, with a requirement to report back on streamlining and the use of dual-use (industrial and defense) parts, specifications, materials and manufacturing capabilities to insure effective, economical surge and sustainability. The comments on "maximized response to early warning indicators" were made to draw attention to the significant impact that proper attention to warning time would have on industrial planning. At present, response has been planned for a war with little or no warning time. Our allies look at this as an invitation to nuclear retaliation with little concern for industrial mobilization. Most of the reports to date, on surge and industrial mobilization, indicate that the problem is too big, and that funding would never be available. In both cases, little or no planning is accomplished. Adequate planning for a real set of emergencies is required, but not available today.

I trust that the comments meet your needs. If you should have need for additional comments, please call upon me.

Sincerely,

Robert B. Costello
Senior Fellow

RBC:kp

RESPONSE TO WRITTEN QUESTIONS TO E. GERALD CORRIGAN FROM SENATOR PRESSLER

Q. 1. In our hearing today on financial services in the 1990s, reference has been made to the buildup of debt. My question pertains to corporate debt, which along with other debt in the United States has grown at an alarming rate during the 1980s. The growth of corporate debt adversely affects tax revenues. In the event of a recession, the continued buildup of debt almost certainly will impede a recovery.

My question is whether there is a way for us to reduce or slow the growth of corporate debt other than by eliminating the double taxation of dividends? Should we not consider reducing the interest deduction on corporate indebtedness thereby discouraging debt over equity financing and at the same time increasing tax revenues? (In this respect, please comment on the advisability of repealing or curtailing the 50 percent exclusion of interest income in lending to ESOPs.)

To begin with, I very much share the stated concern regarding the buildup of corporate debt over the past several years. Indeed, recent developments have, if anything, increased my concerns in this regard. There can be little doubt that this situation does bring with it some risks that economic adversity -- whether regional, national or international in scope or whether growing out of inflation-induced increases in interest rates, recession, or both -- could be accompanied by more serious dislocations and disruptions than otherwise might be the case. While it is impossible to precisely assess, much less quantify, the nature of those risks it is noteworthy that even now -- with overall economic and financial conditions quite favorable -- we are seeing a disturbing number of instances in which highly leveraged companies are experiencing varying degrees of difficulty in meeting debt and debt service requirements growing out of corporate restructuring transactions entered into in the relatively recent past. These developments clearly elevate my concerns about the difficulties which may be encountered in the face of a less hospitable economic environment.

In these circumstances, deliberations as to what changes in public policy -- or private actions -- might constructively slow the growth in corporate debt are both important and difficult. For example, there are approaches -- such as the elimination of the double taxation of corporate income and the introduction of a capital gains tax preference for true equity investments in productive capital resources -- which are likely to work in the right direction. There is also the view that full expensing of investment would promote the buildup of equity. All of these approaches would, however, also entail the major drawback of possibly swelling the budget deficit in the short to intermediate term. On the other hand, proposals to cap or otherwise curtail interest deductibility by some formula -- of which there are many possibilities -- collide head on with a host of definitional and distributional problems which make it exceedingly difficult to judge the effects -- good and bad -- of such tax policy changes in advance. In this connection, the point should also be made that many large institutional investors -- which are a major source of funds for such increases in debt financing -- may choose to make such investments for reasons that have nothing to do with tax policy. In other words, the "supply side" of the debt financing equation is also relevant to patterns of behavior we are seeing.

Since I am not an expert on tax policy I am reluctant to speculate about the merits of one approach versus another. However, it seems to me that two things are of central importance. First, I believe that over time approaches that place relatively more emphasis on positive incentives for *true equity* investments are more likely to produce the desired results than are approaches that seek to rely largely -- if not exclusively -- on efforts aimed at limiting or rolling back interest deductibility. There also may be some scope for melding the two approaches. Second, we must be prepared to permit the marketplace to provide some of the necessary discipline. Elements of that discipline are already in evidence in the form of the very high interest rates that are needed to clear the market of new transactions or to restructure earlier transactions. That discipline may have to be reinforced by investors and/or creditors suffering some losses or interruptions in the orderly flow of debt and/or debt service payments. To put it differently, the mere presence of these very high rates of return are an indication of the high risks associated with such activities. Those who take such risks -- the corporations themselves, their underwriters, their creditors and their investors -- cannot reasonably expect that such high rates of return would be present in a setting in which the risks of default or failure are not commensurately greater than is the case with lower yielding investments. High yield, by definition, means high risk.

Q. 2. What harmful effects might result from large corporate debt?

Before commenting on the harmful or beneficial effects of high corporate debt several introductory points should be made in order to put that discussion in perspective. Foremost among these is that the mere presence (or absence) of high debt ratios at individual firms or in the corporate sector as a whole does not, in itself, provide much insight into the prospects for corporate success or failure or for overall economic well-being. For example, and reflecting relative insensitivity to the business cycle as well as the nature of capital investments, public utilities have, for decades, maintained very high debt ratios relative to most other industry groups. Similarly, conventional measures would suggest that the corporate sector as a whole in Germany and Japan is more highly leveraged than is the case in the U.S. even after taking account of the recent rapid rise in corporate debt in the U.S. Finally, it must also be recognized that individual transactions, such as LBOs, that may increase the leverage of an individual company must be viewed on a case-by-case basis. Here too, the mere increase in leverage of an individual firm should not -- in and of itself -- be viewed as an inherently bad thing, although there is obviously a point where the burdens of excessive leverage will simply overwhelm the firm. Indeed, despite the broad concerns I have about the cumulative effects, I fully recognize that individual transactions that result in increased leverage can produce real benefits to a firm and to the economy as a whole.

With these introductory remarks in mind, at the level of the economy as a whole the most important of the potentially harmful effects of high corporate debt are those that could be encountered in the face of adverse economic and financial conditions. Within that context, there is also the possibility that cash flow problems resulting from softer economic conditions could trigger quicker and sharper cutbacks in production and employment, potentially aggravating an economic slowdown or recession. As an extension of this, there is also the danger that debt servicing problems encountered by a number of highly leveraged firms could have spillover effects into markets more generally. Among other things, this could impair the liquidity of the market for high yield securities. As a related matter, adverse economic conditions could also impair the ability of highly leveraged firms to consummate asset sale programs at expected prices, thereby adding further pressure to cash flow margins and debt servicing capacity.

Over a longer time horizon, the potential harmful effect can include situations in which firms are operating with such thin cash flow margins that expenditures for research, development and investment are restricted, a process that can ultimately undercut competitiveness both domestically and internationally. There is also the danger that firms seeking to protect themselves from takeovers can engage in shortsighted defensive activities that can produce similar adverse results.

Q. 3. What beneficial effects might result from large corporate debt?

The potentially beneficial effects of transactions that increase corporate leveraging must also be viewed largely on a case-by-case basis and in a context in which it is recognized that all other things being equal, more equity is better than less. Unfortunately, other things are not equal.

Thus, one of the beneficial effects of increased debt financing is that it can reduce -- or at least appear to reduce -- the actual cost of capital for individual firms. It is also true -- again, with the emphasis on case-by-case -- that corporate restructurings growing out of LBO-type transactions can produce both combinations of businesses having important economic synergies and/or economies of scale _or_ narrower, more focused businesses and business strategies that offer important competitive advantages. Finally, the reality and the threat of corporate restructurings facilitated by increased leverage can act as a powerful incentive for management teams to conduct their corporate affairs in a manner which promotes greater efficiencies, greater competitiveness and maximizes returns over time.

QUESTIONS FOR MR. REED FROM SENATOR PRESSLER: Is there a way to reduce or slow the growth of corporate debt other than by eliminating the double taxation of dividends? Should we consider reducing the interest deduction on corporate indebtedness thereby discouraging debt over equity financing and at the same time increasing tax revenues? (Please comment of the advisability of repealing or curtailing the 50 percent exclusion of interest income in lending to ESOPs.) What harmful effects might result from large corporate debt? What beneficial effects might result from large corporate debt?

MR. REED'S REPLY: The double taxation of dividends is one of the fundamental reasons for the growth of corporate debt. No doubt there are legislative initiatives other than the elimination of the double taxation of dividends that would reduce or slow this growth. The issue is whether these initiatives would be desirable from the perspective of the overall economy. While there may be legitimate reasons to be concerned about some aspects of the growth of corporate debt, it is possible that the "cure" could be worse than the disease.

Cost of Capital Effects. My judgment is that it would be a mistake to simply reduce the interest deduction on corporate debt for several reasons. Doing so would doubtless increase the cost of capital for U.S. firms, weakening their ability to remain competitive in the global marketplace. Even proposals that purport to be revenue neutral by providing an offsetting deduction for dividends would adversely affect smaller and emerging businesses which are relatively dependent on debt. By the same token, proposals to penalize companies with high leverage ratios or to prohibit certain types of debt would make it more expensive for many businesses, especially start-up ventures, to borrow through intermediaries or to gain access to capital markets. Moreover, since most other developed nations permit a full deduction for interest paid, limiting the deduction in the United States would provide foreign firms an additional incentive to engage in debt-financed acquisitions of U.S. firms.

Capacity to Manage Debt. There are good reasons to believe that the capacity of the U.S. economy to manage higher leverage has increased. As a result of publicity surrounding some large recent transactions substituting debt for equity, many people believe that corporate debt is at an all-time high. But this impression is based upon measures of corporate leverage that do not take into account the large increases in the market value of U.S. corporations. On a market value basis leverage is not out of line with historical experience or with the experience of other countries -- investors clearly believe that the earnings prospects of U.S. corporations justify additional debt issuance. On a market value basis, the ratio of debt to assets of U.S. corporations is now approximately 41 percent -- roughly the same as it was during the 1970s in the U.S. and as it is now in Germany and Japan.

There is a legitimate concern about a possible concentration of the risks of higher leverage within depository institutions. A recent OCC report, however, concludes that banks do a good job of managing their exposure to the risk of default by highly leveraged firms. Bank regulators have proposed new guidelines to ensure that this continues. In addition, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 includes restrictions on the exposure of savings and loans to highly-lveraged corporations as well.

As for the larger risks of corporate leverage, while it is true that increases in corporate leverage may increase the frequency of corporate reorganizations, the economic cost of reorganizations are not likely to be large. Federal bankruptcy laws and opportunities for privately-arranged corporate restructurings minimize the economic disruptions that result when a firm is unable to meet its commitments to its creditors. In many cases, a corporation can continue normal operations and jobs can be preserved. Clearly a recession in the next year or so would hurt some companies and lead to job losses. But these effects would occur whether corporations are heavily indebted or not. The built in bias of our bankruptcy laws toward rehabilitating a debtor rather than liquidating it ensures that the effects of a recession on the economy will be no greater even if firms are more highly leveraged than in the past.

Effect on Treasury Revenues. As for the effects of leverage-increasing transactions on U.S. Treasury revenues, the available evidence indicates that they are not necessarily negative over a period of time. A Treasury official recently acknowledged this in testimony before the House Ways and Means Committee. Increases in tax revenues from capital gains, asset sales, interest payments by creditors and higher incomes from better use of capital resources may outweigh the direct revenue losses resulting from the substitution of debt for equity. The available empirical studies have not gone unchallenged. But while more study is needed, evidence does not support the conclusion that higher leverage reduces Treasury revenues.

ESOPs. The 50 percent exclusion of interest income from loans to Employee Stock Ownership plans is a form of tax preference which has had an influence on market behavior. Congress initiated this preference for a specific reason -- to encourage stock ownership by employees of corporations. Congress must determine whether this reason is still valid. Whether or not the 50 percent exclusion is retained, employers seeking to boost productivity by giving employees a stake in the firm will continue to be adopt ESOPs. But eliminating the exclusion will lead to fewer ESOPs and fewer employees participating. Employees, not lenders, are the primary beneficiary of the program.

Benefits from Higher Leverage. There are potential benefits associated with increases in leverage. The substitution of debt for equity imposes constraints on management that can benefit shareholders and the economy. Binding management to pay out cash in the form of interest may actually enhance the ability of capital markets to direct capital resources to their most productive uses. Academic studies show that leveraged-buyouts, for example, give owner/managers, who have a high stake in the success of the firm, a very strong incentive to seek maximum performance for the corporation. Sales volumes, operating earnings and cash flow generally increase, both absolutely and relative to other firms, following leverage-increasing financial restructurings. Typically, leveraged-buyout companies sell off unproductive assets in the year of an ownership change, but then engage in new capital outlays to create a stronger, more competitive economic base. There is no evidence to support the claim that leverage-increasing transactions are associated with widespread job losses.

To date, the increased debt of U. S. corporations has not led to widespread problems. American economic, corporate and legal structures have the flexibility and resilience to cope with a more highly leveraged corporate environment. If excesses are developing, the marketplace should sort these out. At the same time, there is a danger that ill-conceived proposals to discourage leverage will instead discourage economic growth and place U.S. firms at a competitive disadvantage relative to firms in countries where interest expense is deductible.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN
FROM NORMAN AUGUSTINE

Question 1: Within the larger context of the difficulty of doing business in the defense marketplace, you spoke of the U. S. industry "burdened" with technology transfer restrictions. You said that these controls force companies, that want to supply foreign defense systems, out of the United States for research, development, and production. As a representative of American aerospace industry, what are your feelings about transferring aerospace production technology to trading partners, like Japan, in the FSX deal, and Korea?

Answer:

My answer to this question needs to be qualified in that Martin Marietta is not directly involved in either the Japanese or Korean programs. Therefore, I am not familiar with the specific technology transfer parameters being discussed. In general, I have no problem with transferring current production technology to our allies and other friendly nations for national security purposes. Leakage of critical technology to the East is not, in most cases, a major concern. Our current technology transfer system is overly restrictive in this regard and may, as the question points out, actually work against U. S. interests in some cases. As a country, we have consistently urged our allies to strengthen their defense industrial capability in order to better serve our collective security needs, and to increase their share of contribution to our common defense. Transfer of production technology helps them do this. One can argue that it is more efficient for other countries to procure already developed off-the-shelf systems, but the U. S. has always respected the right of other countries to provide for their own indigenous defense industrial base requirements, as we do in the U. S. by requiring domestic production of foreign procured systems.

The issue of technology transfer becomes more complex if U. S. industrial base considerations are included. Companies don't want to set up future competitors either in the global marketplace, or even in their own domestic markets. However, companies who must compete are, in general, in the best position to make such technology transfer decisions insofar as commercial applications are concerned, not the U. S. Government. Furthermore, in today's highly industrialized global marketplace, U. S. technology is not the only available option for most systems. Denial of technology for industrial base purposes will force our allies to look elsewhere, weakening not only an important security relationship, but jeopardizing commercial relationships as well.

Question 2: What critical technologies do you envision being primary factors in U. S. industrial competitiveness and defense preparedness in the 1990's?

Answer:

There is general consensus in the aerospace industry that technology development is the key to international competitiveness. In the last year, based on study of more than 100 technologies, the industry has developed a view, which I support, that there are nine technologies which are critical both to our industrial competitiveness and to defense preparedness. These are:

Composite Materials

Stealth Designs and Associated Technology

Very Large Scale Integrated (VLSI) Circuits

Software Development

Propulsion Systems

Advanced Sensors

Optical Information Processing

Artificial Intelligence

Ultrareliable Electronic Systems

In each of these technology areas, while the detail of focus and application may vary among organizations, it is my perception that action is underway to develop and implement executable plans and actions that will ultimately realize the competitiveness and preparedness payoff that technology can make.

Question 3: In your considered opinion, would it be a good or a bad thing for American industrial competitiveness, and for the American defense industrial base, to offer, as part of an amendment to the Defense Production Act, immunity from antitrust laws (rather than a defense in antitrust actions) and comparatively lenient requirements for forming a consortium? Specifically, would such an offer address your concerns about the defense industrial base, and American competitiveness in general?

Answer:

Current antitrust legislation can, in some cases, work against U. S. industrial base interests. There is a fine line between encouraging greater collaboration to compete globally, and maintaining strong domestic competition which is the cornerstone of our economic strength. Actions taken to establish MCC (Micro Electronics and Computer Technology Corporation) and Sematech represent a good compromise permitting companies to pool resources for the development of basic technology that can then be utilized individually by competing companies for development of competing products. I do not favor changes to antitrust rules that would facilitate the dissolution of our competitive free enterprise system; however, I do believe anti-trust laws should be applied on a market-wide basis and not on a geographical (domestic) basis.

Antitrust exemptions, such as applied to Sematech, are not in and of themselves a panacea for curing U. S. defense industrial base problems. Other policies should encourage, among other things, greater investment in facilities, development and retention of a skilled labor force, better planning based on long-range objectives, and development of a more equal base for international competitiveness.

Robert W. Galvin
Chairman of the Board

August 10, 1989

Senator Jake Garn
United States Senate
Committee on Banking, Housing,
and Urban Affairs
Washington, DC 20510-6075

Dear Senator Garn:

Questions have been submitted to me by your office as per the attached photocopy. Herein are my responses to those questions:

Q.1 Mr. Galvin, you mentioned Sematech, the semi-conductor industry consortium, in your testimony. We are hearing a lot about Sematech and the joint production of D RAMS. In a general way, does the American electronic industry think that joint development and, perhaps, production is a good thing?

Q.1 The American electronics industry, in general, believes that joint development and production is a good thing.

Q.2 In your considered opinion, would it be a good or a bad thing for American industrial competitiveness, and for the American defense industrial base, to offer, as part of an amendment to the Defense Production Act, immunity from antitrust laws, (rather than a defense in antitrust actions,) and comparatively lenient requirements for forming a consortium? Specifically, would such an offer address the your concerns about the defense industrial base, and American competitiveness in general?

Q.2 An amendment to the Defense Production Act providing sufficient immunity from antitrust laws vis-a-vis consortiums and joint efforts within the industry would be a favorable benefit.

Q.3 In your statement, you cite several reasons for competitive decline in industries that are critical for national defense. One such reason is the industry's "demonstrated difficulty" translating or applying breakthroughs made by the research community into competitive products. Why, do you think, industry has this problem? What role can government play in the effort to solve this problem?

Q.3 There are many other factors affecting the competitive status of American industry than the apparent difficulty of translating certain developments achieved under defense research and development contracts into commercial products, but, nevertheless, it is a factor with some real consequences. I have not analyzed that subject in great detail, but, partially, the reasons there have been insufficient conversions are that some of the end result of the research is so highly focused that it is not automatically transferrable to a commercial application. Additionally, there are occasionally clouds over what the proprietary ownership of the research may be. I do, incidentally, favor that the patent holdings be in private hands with certain obligations as to licensing in a responsibile way, but that may be holding some people back.

Although I have no personal experience on the following, because of our sensitivity to contract compliance, it is quite possible that some organizations are sensitive to using or adopting things that have been developed on government contracts for fear that there could be an interpretation that they have failed to comply with a fairness principle of some kind.

Q.4 You suggest that one needed change is the implementation of a meaningful trade policy with Japan. When you state that "many fine defense contractors have attempted to confront the challenge and deny sanctuary to our competitors in Japan, but the lack of trade policy has made our efforts difficult." What do you mean?

Q.4 Let me describe my point of view on that in a more general way than trying to directly respond to the words of your question: There are two principles of strategic thinking that are insufficiently emphasized. One is the importance of writing the rules and the other is to prevent others from having a sanctuary.

We describe this latter as the principle of sanctuary. In military parallax if one's rival can literally go home over the border, rest and load one's gun, then in the morning he can return to the battlefield fresh, do mischief and still go back over to the sanctuary again if we don't follow into his home territory.

That same is true in commerce. If we permit our competitors in Japan to have a sanctuary in their home market, they can strengthen themselves there, come and do mischief in the United States, which the Japanese have done very extensively in many businesses over decades, then they go home and refresh themselves. If one does mischief enough one can hurt the local competitor and in some instances ultimately cause the demise of sections of industries.

We must have an ability to write rules that permit us to prevent people having sanctuaries, but the private sector cannot write the rules in Japan. We continuingly need the assistance of the United States Government to see to a balanced expression of rules and right-of-way in accomplishing fair commerce between rivals. This has not been appreciated in our country; it needs to be ever better appreciated.

In those individual cases where it is appreciated and assistance is given or facilitated by the U.S. Government, companies like ours can compete viably in a market like Japan. As a matter of fact, we are successful in Japan for the simple reason that we have claimed the need to write better rules and have challenged the Japanese to their retention of sanctuary. Happily, we have been supported often by some of our government officials to provide the means of a competitive environment in which we could succeed. But this is still insufficient for industry in general and partially insufficient for us. Our nation must come to appreciate better the necessity to stand up for the right rules.

Q.5 What critical technologies do you envision being primary factors in U.S. industrial competitiveness and defense preparedness in the 1990s?

Q.5 All of the material, equipment and systems technology imaginable in electronics, in chemistry and in physics will play a critical role in U.S. industrial competitiveness in the years ahead. We must practice these technologies. When we get an idea as to a useful technology, the means must be created wherein either in the free flowing commercial market there must be an offering and an acceptance at the market place, or in some instances there will have to be the subsidization of the practice of some of these technologies until such time as a market is awakened.

Best wishes,

Robert W. Galvin

GENERAL DYNAMICS CORPORATION
Pierre Laclede Center
St. Louis, Missouri 63105

Stanley C. Pace
Chairman and Chief Executive Officer

314-889-8295

29 August 1989

The Honorable Donald W. Riegle, Jr.
Chairman
United States Senate
Committee on Banking, Housing, and
Urban Affairs
Washington, DC 20510-6075

Dear Senator Riegle:

Following are my responses to the questions from Senator Garn attached to your letter of August 1, 1989.

1. As a representative of American aerospace industry, Mr. Pace, what are your feelings about transferring aerospace production technology to trading partners, like Japan, in the FSX deal, and Korea?

> The transfer of aerospace production technology must be viewed in the context of three primary considerations: national security, foreign policy, and economic self-interest. Since the first two areas of consideration are almost exclusively the provinces of both the executive and legislative branches of government, I will limit my comments to the third area of consideration. I do so because I view industry's role in the former two areas as largely being one of carrying out United States policy. Nevertheless, I would also caution that American industry's ability to conduct successful international sales of defense and defense-related products will, to a great extent, be a function of our government's willingness to weigh carefully our foreign and national security policy objectives against the technological and economic benefits to be derived from such sales. We believe the balancing of those objectives and benefits is precisely what happened under the FS-X program and is currently being structured into the Korean program.
>
> The transfer of production technology in furtherance of economic self-interest is rightfully a concern of both government and industry. In that regard, I firmly believe that individual decisions by both the government and industry to transfer or withhold technology will and

should result naturally from the bargaining process. The bargaining process enables the parties involved to exact consideration from each other in furtherance of their own distinctive competencies and their relative competitive priorities. If a company or the government believes that such a transfer would be inimical to its own self-interest, it will seek to protect that technology from release. And we believe this is as it should be.

In the case of the FS-X program, both the Administration and General Dynamics have been careful to ensure that the critical digital flight control technology, a technology that might have commercial airplane application, will be protected. In fact, the company, in conjunction with DoD, will institute a three-pronged system to safeguard the "how" of the basic F-16's designed technology.

I also believe we must recognize that the U. S. aerospace industry is a part of a more populous international defense marketplace in which we must remain highly active participants. American aerospace companies must be given the latitude, and even encouraged, to compete as often as possible for foreign sales of defense and defense-related articles. The price of participating may sometimes be the transfer of technology, but I believe that multiple and significant advantages accrue to industry, the general economy, and the government by maintaining a large presence in the defense marketplace. In fact, I believe that our leadership in the aerospace industry will not only be preserved but also enhanced by working and competing in the international arena.

Your next two questions I would like to address with a consolidated response. The questions are:

2. As part of the solution to the diminishing margin of American technological superiority, you suggest long term continuing funds for Independent Research and Development will contribute significantly to the development of innovative quality defense products. You have not referred to the desirability of easing the requirements for forming a consortium. If you were asked to change the Defense Production Act, with the goal of a strong industrial base in mind, would you choose to alter the provisions governing consortiums and antitrust?

3. In your considered opinion, would it be a good or a bad thing for American industrial competitiveness, and for the American defense industrial base, to offer, as part of an amendment to the

Defense Production Act, immunity from antitrust laws, (rather than a defense in antitrust actions,) and comparatively lenient requirements for forming a consortium? Specifically, would such an offer address your concerns about the defense industrial base, and American competitiveness in general?

> First, it is important to recognize that the major products of the defense industry, i.e., weapons systems, and their market are usually characterized by very advanced technology, high research and development costs expended over a long period of time, high costs of end products and, essentially, a single customer base. These are characteristics not all found with respect to other products and markets. Second, the trend toward forcing contractors to share front end research and development and production costs and risks is making it more difficult to attract or commit capital to very costly efforts. A consequence is the need to create joint ventures, even among competitors, for specific objectives.
>
> A number of laws provide some relief from the basic antitrust laws that are available to the defense industry. While one of these is the Defense Production Act (DPA), the DPA antitrust law section is not a very effective law. It is not clear what the statute really covers. While it speaks to "Voluntary Agreements," what Voluntary Agreements means, that is, whether the term includes just consortia or also joint ventures, including joint ventures for research and development and for production, is undefined.
>
> As currently written, the DPA, also, does not provide antitrust immunity for participation in Voluntary Agreement programs. It provides only a defense against antitrust charges, which defense, to be successful, must include a showing that the challenged action was taken in good faith and in compliance with the terms of the Voluntary Agreement. The extremely limited use of the procedures afforded by the antitrust provisions of the DPA, and implementing regulations, is strong evidence of the limited value of the statute.
>
> Any amendment to the DPA, or to the restraints of the antitrust laws generally, to be of benefit to the defense industry would have to permit the formation of joint ventures, even of competitors, for research and development or for production, where the objectives have hurdles of costs and resources too large and selective to be reasonably expected as an undertaking of a single enterprise.

Statutes such as the Joint Research and Development Act of 1984 and the National Cooperative Research Act are illustrative of approaches more effective to provide relief from antitrust restrictions than the DPA antitrust section. The National Cooperative Research Act has been utilized in the formation of a defense related software research consortium. But these laws, and particularly the Joint Research and Development Act of 1984, are addressed to industry generally. The need of the defense industry for immunity or other relief from the restraints of the antitrust laws should be driven by the need to put industrial resources together in a manner to serve best the national defense interests. Antitrust concerns ought not be deterrents to these ends.

The immunity or other relief should, in addition, extend to State laws similar to the antitrust laws. Perhaps an approach is one that would provide, under defined circumstances, antitrust immunity along with the event of contracting in the case of agreements between the government and a defense industry joint venture, the immunity, or other relief, being effective also against challenge by private interests.

I use "joint venture" in these remarks in its broadest sense, i.e., including consortia, separate entities, or mere contractual arrangements. In my opinion, it would be beneficial to the industry and to the national interest for the defense industrial base to be permitted to form joint ventures with immunity from, or having a less degree of exposure to antitrust restraints.

4. What critical technologies do you envision being primary factors in U. S. industrial competitiveness and defense preparedness in the 1990's?

On 2 June 1989, Mr. R. Noel Longuemare presented testimony to the Senate Armed Services Committee's Defense Industry and Technology Subcommittee concerning the Aerospace Industry Association's (AIA's) "Key Technologies for the 1990's Program." This AIA sponsored program reflects its membership's concerns about some existing weaknesses in U. S. industry's research and development processes and, as Mr. Longuemare stated, "seeks to make the expensive process of technology development more affordable by taking advantage of the momentum and efficiencies inherent in a national cooperative program."

In his testimony, Mr. Longuemare described ten key technologies for which "roadmaps" were being or have been created to guide the development of a generic technology bank, from basic research through the technology development phase. Those technologies include: rocket propulsion, advanced sensors, artificial intelligence, software development, airbreathing propulsion, advanced composites, ultra-reliable electronic systems and optical information processing, superconductivity, and computational science.

General Dynamics wholeheartedly endorses this cooperative and pragmatic attempt to muster the combined forces of industry, academia, and government laboratories toward a national technology development effort. In conjunction with DoD's recent designation of 22 crucial technologies warranting funding priority pursuant to the Defense Authorization Act of 1989, I believe there is now a universal recognition of the need to develop a national consensus on selective technologies having, to use Mr. Longuemare's words, "the highest leverage, greatest potential payoff and broadest applicability to both civil and military products." I further believe that industry and government recognize the need to reevaluate constantly the criticality of these technologies while promoting pooled and cooperative efforts to bring them quickly to fruition to beat the competition to market. At the same time, I would like to reemphasize my strong belief that we should never neglect the critical importance of the aerospace industry's independent research and development (R&D) programs, the true lifeblood of industry's broad underlying technology base and product innovation that has been responsible for a majority of our new and effective weapon systems.

Sincerely,

GENERAL DYNAMICS CORPORATION

Stan Pace

Stanley C. Pace
Chairman and
Chief Executive Officer

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE
FROM LARRY CHIMERINE

Q.1. Mr. Burstein, who also testified on November 14, stated on page 7 of his prepared testimony that:

> "...financial resources have replaced natural resources as sources of geopolitical power and influence...and the fact that Japan has obtained a disproportionate share of global financial power will fundamentally tilt the history of the 1990s and the early 21st Century towards Japanese leadership."

- Do you agree with his view?

1. I agree with Mr. Burstein that the Japanese have acquired enormous financial power in recent years and that these financial resources will enable the Japanese to dramatically increase their geopolitical power and influence. I further agree that financial resources have now become more important than natural resources, especially since (a) manufacturing as a share of output in industrialized countries is declining; (b) many manufactured goods are being downsized; and (c) new synthetic materials are replacing some traditional natural resources. It should be emphasized however, that it is Japan's competitiveness in the production process, as well as their high internal saving rate, that have enabled them to build their financial strength.

Q.2. During a hearing we had on October 5 on the condition of our banking system at which various industry experts testified, one expert, Mr. Sheshunoff expressed concern over the rapid expansion of foreign banks in this country. He stated:

> "Over the long term, control over a nation's financial institutions means control over which individuals and businesses are provided with credit and allowed to grow."

- Do you share Mr. Sheshunoff's concerns. If so, why? If not, why not?

2. I believe Dr. Sheshunoff's concerns are somewhat exaggerated because it is unlikely that foreign owned banks or other financial institutions will deny credit to worthy borrowers in the United States. However, it is true that the increase in foreign banks in this country will increase the influence that foreign countries have over our economy. As in other sectors of the economy loss of ownership means loss of control. In addition, to the extent that Japanese institutions repatriate some of the profits earned from their financial institutions here, it just gives them more resources at home to further improve their relative position in the years ahead.

Q.3. At that same October 5 hearing another banking expert, Dr. Kaufman, said the critical element in dealing with the rapid expansion of Japanese banks in this country is that U.S. banks in Japan should have access to lower priced Japanese savings so they can raise the same pool of funds and channel it back to our country if its needed here?

- Do you agree with Dr. Kaufman?

3. I agree with Dr. Kaufman that U.S. banks should have the same freedom to locate in Japan that Japanese banks have here in the United States. This will be important in two respects, namely by allowing U.S. financial institutions to raise money in Japan for use in this country, as well as to enable U.S. financial institutions to take advantages of the economies of scale and opportunities that arise from a global presence. It should be noted, however, that Japanese banks located here in the United States are not primarily in business in order to take U.S. capital and invest it outside the United States — their primary role is to find additional outlets in this country for capital generated in Japan. If that pattern continues, their presence in this country has the beneficial effect of adding to the supply of capital here.

Q.4. Former Secretary of the Treasury Donald Regan and other advocates of the Reagan/Bush economic policies have told this Committee that the growing foreign investment in our economy is not a bad development, but rather is a reflection of the confidence foreigners have in our stable political environment and business climate.

- Do you agree with that assessment? If not, why not?

4. Former Secretary Regan's assertion that growing foreign investment in our economy is primarily a reflection of foreign confidence in the U.S. is a gross overstatement. First, as any visitor to Japan would quickly learn, the Japanese (as well as many leaders in other countries) are bewildered by our unwillingness or inability to address some of the fundamental problems in this country, such as our low saving rate, poor productivity, massive budget deficits, deteriorating quality of education, etc. As a result, many of them have a rather pessimistic view of the future of the U.S. economy. Second, the increasing amount of foreign investment in this country to a great extent reflects the other side of massive trade surpluses that especially the Japanese have had with the United States — these

surpluses, primarily reflecting their competitive advantages, have generated massive dollars which in turn get re-invested back in the United States. In addition, the declining trend of the dollar on foreign exchange markets has made U.S. assets less expensive than those in other countries, and our relatively high interest rates means a higher return on various investments. These are the among the major reasons for foreign investment here, and none of them are signs of strength.

Q.5. Mr. Burstein stated on page 18 of his prepared testimony that:

> **"the U.S. trade deficit is now being compounded by the even worse current account deficit, and this will become a bigger problem over time as Japanese companies begin to repatriate their profits from the American market causing another major drain of dollars out of the system."**

- **Do you agree with Mr. Burstein's contention?**
- **What are the future implications of this development?**

5. I do agree with Mr. Burstein that the U.S. current account deficit will exceed the trade deficit in the years ahead, reflecting an outflow of interest and dividends on our growing foreign debt. The longer that this situation continues, the larger that the eventual adjustment will have to be in our trade accounts in order to produce an overall balance. This could mean even additional downward pressure on the dollar in the years ahead and/or higher interest rates than otherwise would be the case. Furthermore, and perhaps most importantly, the outflow of interest dividends and profits will essentially suck increasing amounts of income out of the U.S. In other words, the burden of our foreign indebtness will grow in the years ahead, especially if productivity growth and therefore overall economic growth do not accelerate.

Q.6. Mr. Burstein stated on page 22 of his prepared testimony that:

> **"...while our political leaders are busy spreading the gospel of free markets, our competitors are using intelligent, consciously - devised, government - led strategies to better manage their trade policies and the functioning of their market."**

- **Do you agree with that contention?**

6. I agree with Mr. Burstein that other governments are less free-trade oriented then we are in the United States, and in many cases have trade policies which are more consistent with the goals of the domestic economy than we do here. I also agree that we should take whatever steps are appropriate to overcome this by pressuring other countries to open their markets and/or change other features of their economies that either inhibit their imports or subsidize their exports. However, I do not think that this is the main reason for our massive trade deficits in recent years — the truth is that there has been a fundamental erosion of U.S. competitiveness, which in my view explains far more of our current massive trade imbalance than does unfair trade practices overseas.

Q.7. You have pointed to our huge budget deficits as an overriding problem that we must solve to boost our national savings and investment. I am also troubled by our low private saving rates. Net saving rates of households and firms in the past 8 years are only about 2/3 what they averaged in the previous 35 years. Why is that? What can we do about it?

7. The available evidence does not provide a clear picture as to why saving rates in the United States have declined in recent years. In my judgment, there are several factors that have contributed to this trend -- these include the following: (a) the sharp increase in housing prices and the prices of various financial assets which increased household and corporate wealth, reducing the need for new savings; (b) the relatively slow growth in real incomes, which caused many families to cut their savings in order to either maintain, or to continue to improve, their living standards; (c) the increasing competitive environment, which has reduced profit margins in many industries and thus reduced corporate savings; (d) relatively high interest rates, which has had the reverse effect of holding down savings because less new savings are needed since returns are now higher on previous savings.

Q.8. As our social security fund builds up to pay for future benefits, we're taking the money and using it for current spending. Where will we get money to pay those benefits? Should we be trying to balance the budget as we currently measure it, or should we be trying to balance it without using social security funds?

8. In my judgment, there is no proven way to increase personal savings. In fact, as implied above, savings rates have declined sharply during the 1980's despite various tax changes and other incentives which were designed to increase savings. And it is not clear that consumption taxes, including a value added tax, would increase consumer savings (over and above the direct impact on the federal deficit). In my view therefore, the most practical way to increase national savings is to substantially cut the budget deficit. With respect to the social security trust fund, it is true that we are now essentially using social security surpluses to finance ongoing federal government expenditures. Thus, sometime early in the next century, when annual social security surpluses begin to decline and eventually disappear, the unified budget deficit will grow dramatically unless steps are taken to either slow the growth in expenditures or raise taxes. Without a coherent policy, either a massive increase in social security taxes, or a sharp decline in benefits, or massive other tax increases and/or cuts in other expenditures will then be needed to pay out social security benefits. In my judgment, we should set the social security trust fund aside since current surpluses are being generated in order to fund future benefits, and thus deal with our budget problem excluding the social security trust fund.

Q.9. If we continue with our current policies, how do you foresee our trade and current deficits evolving? Can they continue like this indefinitely? If not, what will ultimately restrain them?

9. In my judgment, it is unlikely that we are going to see a major improvement in our trade or current account deficit (barring a major recession and or further sharp declines in the value of the dollar) unless current policies and trends are reversed. In particular, it is essential that we take steps to reduce our budget deficits, and at the same time bring about an improved trend in productivity growth and competitiveness. Otherwise, it is inevitable that foreigners will some day reach the point where they become saturated with dollar assets and become unwilling to increase their holdings of such assets, or even worse, may not be willing to hold all of what they have already accumulated. If that were to happen, enormous downward pressure on the dollar and/or a sharp increase in U.S. interest rates would take place, probably leading to a major recession. No one can predict when and if this will happen. The risks will continue to grow, however, as long as our foreign debt continues to rise as rapidly as it now is.

Q.10. Despite all the foreign capital that has poured into our economy, capital per worker in private business has hardly budged since 1981, after doubling in the previous 35 years. How critical is that to our future income growth?

- **Can you quantify in some rough way what the cost of our current policies is in terms of our future income?**

10. In my view, the most disappointing developments of the 1980's were 1) that private savings fell, 2) that we have not corrected our large fiscal imbalance, which has caused a further decline in national savings, and 3) that net investment has not increased despite the long economic recovery and despite the enormous inflow of foreign capital. In effect, we are not building for the future; quite the contrary, most of the underlying forces that will effect future economic growth are actually less favorable now than they were 10 years ago. We are basically borrowing from the future. It is difficult to calculate precisely what the cost of recent policies will be in terms of future income growth but in my judgment, an average of one half percent - one percent per year in growth for the decade of the 90's is not unreasonable.

Q.11. You stated on page 7 of your prepared testimony that many American families, in order to compensate for a dramatic slowdown in the productivity growth of our economy and a stagnation in the growth of real wages, have gotten along by relying on second incomes and by cutting savings and/or going deeper into debt in order to maintain living standards.

- **Do you think that we are now at the stage that unless we deal with our productivity problem, the real standard of living of Americans will begin to decline.**

11. I believe that real incomes and living standards in the United States have begun to stagnate and that this process will continue for many years into the future. Furthermore, there is no evidence at this point that the underlying trend in productivity growth (once the cyclical rebound is factored out) has improved significantly from the weak pattern in place since the early 1970's and, with corporate debt loads extremely high, with the quality of our education declining, with our technological leadership eroding at a rapid pace, and with net investment still relatively low, it is difficult at this point to be optimistic that in fact a meaningful up-trend in productivity will develop anytime soon. Thus, as mentioned above, there is no question in my mind that average living standards will not grow for many years into the future and that in fact, a modest decline could take place.

Q.12. Mr. Burstein on page 27 of his prepared testimony expressed optimism about America's ability to deal with its competitiveness problem because in his view "America is waking up". You, on the other hand, were pessimistic on page 8 of your testimony because our country's unfavorable trends are not receiving adequate attention. Can you each explain in more detail why you are optimistic or pessimistic?

12. I do believe that Mr. Burstein is correct in the sense that more and more Americans are finally beginning to recognize that there is a fundamental problem in this country and that the economic recovery of the last seven years has been largely cyclical in nature and has overshadowed deteriorating fundamentals. This is clearly a plus because no attempt to reverse these trends is likely until we first admit there is a problem. However, at this stage I see no evidence of any fundamental policy changes or new approaches that will address our problems. In particular, it seems to me that we are still not getting the leadership at the national level that will lead to a change in direction and to new approaches in the private sector. For example, while we are now finally beginning to admit that the quality of education is unacceptably low in this country, there has been almost nothing of any substance done which will ultimately lead to an improvement in quality. The same is true for inadequate savings, for the relatively low investment rate, for the high cost of capital, for the short-term business horizon, etc. Thus, in sum, it is encourging that more thoughtful and caring people are admitting there is a problem but until there is stronger action at the national level, I believe it is premature to expect any improvements any time soon.

Q.13. An October 1988 publication of the Department of State's Center For The Study Of Foreign Affairs entitled "Japanese Investment In The United States" argues that:

> "Japanese investment in qualitatively different than other foreign investment in the U.S. because [in part]... Japan is far more closed to American investment than are other countries investing in the U.S."

- Do you agree that Japanese foreign investment is in some qualitative way different from investment from other foreign countries?

13. In terms of the effects on financial markets, I do not believe that there is any difference between Japanese investment in the United States and investment from other countries. There may be significant differences in direct investment however; the Japanese seem more willing to introduce their management techniques, their technology, etc. into the manufacturing companies and other direct investments they make in the United States. I do agree with the basic point however, that the Japanese have more freedom to invest here than we do there and that this imbalance should be addressed. Furthermore, there is a psychological difference between Japanese investment and others, in the sense that there is more fear in this country that the Japanese will ultimately dominate the U.S. economy, than there is with respect to other countries. Thus, I think people are "more afraid of Japanese investments than those from other countries."

Q.14. As you know many Americans are increasingly concerned over rapidly increasing foreign ownership of U.S. assets. Can you explain to us in a clear and concise fashion how increasing foreign ownership of America's assets is, in your view, related to our budget deficits?

14. In my judgment, the relationship between our high budget deficits and Japanese investment in the United States is in-direct — large budget deficits have increased our trade deficit by putting upward pressure on interest rates, thereby causing an over evaluation of the U.S. dollar in the early 1980's. This combined with the direct effect of large budget deficits on demand, increased our trade deficits, thereby increasing the amount of dollars that the Japanese and others were earning which ultimately were re-invested back in the United States. In my view, however, this was only one factor and perhaps not even the major factor behind our trade deficits and behind large foreign investment — in my judgment, a deterioration in underlying competitiveness was at least as important as budget deficits in the changing role of the U.S. economy during the 1980's.

Q.15. How much comfort can we take from the fact that, unlike Third World debtors, our foreign debt is denominated in our own currency?

15. The fact that our foreign debt is denominated in dollars makes it very different than the situation that many third world countries find themselves in. The major reason for this is that our debt situation is essentially unaffected by any change in the value of the dollar since it is already dominated in dollars. This is different for example than the situation in Mexico, because their debt is also dominated in dollars but when their currency depreciates relative to the dollar, their debts measured in their own currency become even larger. There are of course other differences between the United States and the debtor nations in Latin America and elsewhere — in our economic strength, in the breadth of our financial markets, in our productivity levels, in our credit worthiness, in political stability, — etc. which makes it somewhat dangerous to compare our situation with those in some of these other countries. Nonetheless, it is also foolish to ignore the fact that the increase in foreign debt in the United States will ultimately hold down living standards and will in fact become a bigger and bigger burden as we move into the future.

Q.16. Dr. Chimerine, in your prepared testimony you listed several components of a national strategy to boost productivity growth, including a) cut the budget deficit; b) raise private savings; c) channel savings to productive investment; d) raise non-defense R & D; and e) improve the quality of education.

- **What specific steps would recommend to channel savings to productive investment? To increase private savings?**

16. As I mentioned earlier, I find it very difficult to have any confidence in any recommendations designed to increase private savings. Therefore, my focus would be to increase national savings by cutting the budget deficit, and to find ways to channel a larger fraction of our national savings into more productive investments than we have in the past. In this regard, I would suggest the following 1) at the national level, I believe it is important to shift the allocation of our expenditures increasingly away from entitlements, defense, and other current programs into education, job retraining, and other programs which are likely to have a bigger impact on productivity; 2) consideration should be given to tax changes which would reduce speculation and the focus on financial transactions, and encourage more long-term investment. Such measures could include a sliding scale capital gains tax cut, scaling back the interest deduction for mergers, acquisitions; etc. Furthermore, I would apply any such tax changes only to productive type investments, rather than for collectables, homes, etc. 3) Serious consideration should be given to scaling back the mortgage interest deduction, particularly for higher priced homes.

One way to do this would be to permit interest to be deducted on only the first $150,000 (this is arbitrary of course) — if the homeowner wants to buy a larger home, he should be on his own thereafter. 4) While I recognize the deficit problem confronting us, I think consideration should be given to restoring the investment tax credit. But because we don't have sizable funds to give away, it should be constructed so that we don't give the credit for investments that would have been made without it. Thus, I am suggesting an incremental investment tax credit — that is, a large credit on expenditures over and above some base level. This would be far less expensive than the old investment tax credit, yet be very effective at stimulating investment at the margin. 5) On the revenue side, I believe that the tax increases that we put in place should be those that would most likely curtail either current consumption, or speculative activity. Thus, I would consider a stock transaction tax, and certain excise taxes, rather than a general income tax.

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Responses to Questions from Senator Riegle in his letter of December 11, 1989 following the hearings of November 14, 1989 at the U.S. Senate Banking Committee

Q.1. Mr. R. Taggart Murphy of the Chase Manhatten Bank in Tokyo claims in the March/April issue of the Harvard Business Review that:

> "Japanese commercial and investment bankers have succeeded overseas partly because of their diligence and attention to detail but also because they can offer lower spreads and lower fees to borrowers, thanks to the profits they enjoy from a cartel - like, protected market at home."

- Do you agree with Mr. Murphy's views and if so what should our government do to help American banks break into Japan's cartel - like protected market at home?

1. Yes, Japanese financial institutions owe some of their success abroad to their dependable, profitable protected market at home. I believe, however, that they owe a greater portion of their success to the overall structure of the Japanese financial and economic system--including regulatory stability, cross-shareholdings with industrial companies, the high value of the yen, the Japanese trade and current account surpluses, the low inflation rate, etc.

Political, legislative, and other negotiating efforts on the part of the U.S. to open the Japanese financial market to American participation, while commendable symbolically if they are presented reasonably, are not likely to achieve too much more than they already have. In part, this is because we have very few cards in our hand. In larger part it is because all we can win through negotiation is the further easing of overt barriers--most of which have already been dropped. The real obstacles, however, are the hidden barriers of Japanese business culture.

The most effective way U.S. financial institutions can compete with the Japanese institutions is to enhance the stability of our own financial system, raise our savings rate, and strengthen the value of the U.S. dollar. If we had a dollar that was worth 200 yen, and a large supply of domestic savings driving the prime rate toward 5%, the environment would be quite favorable for American financial institutions. That basic situation could be further bolstered by a meaningful prudential regulatory system that, while avoiding Japan's extremes of over-regulation, prevented some of the recent excesses, failures and explosive costs we have seen.

Q.2. During a hearing we had on October 5 on the condition of our banking system at which various industry experts testified, one expert, Mr. Sheshunoff expressed concern over the rapid expansion of foreign banks in this country. He stated:

> **"Over the long term, control over a nation's financial institutions means control over which individuals and businesses are provided with credit and allowed to grow."**

- **Do you share Mr. Sheshunoff's concerns. If so, why? If not, why not?**

2. Mr. Sheshunoff's observation seems accurate and conforms to my own. While the Japanese may have no ill intentions towards us at present, it is extremely rare in economic history to find those who exert a dominating influence on financial markets remaining entirely disinterested in the basic structures of those markets. At some point in the 1990s, we will begin to see a Japanese strategy or strategies influencing our lending and financing.

Q.3. At that same October 5 hearing another banking expert, Dr. Kaufman, said the critical element in dealing with the rapid expansion of Japanese banks in this country is that U.S. banks in Japan should have access to lower priced Japanese savings so they can raise the same pool of funds and channel it back to our country if its needed here?

- **Do you agree with Dr. Kaufman?**

3. I agree with Dr. Kaufman in principle. In point of fact, however, it must be acknowledged that the evolution of financial instruments has made it possible for large U.S. borrowers to tap the low-interest yen bond market. I am not sure at the moment, however, if that is an advisable strategy for U.S. corporate borrowers (and I think it would be an extremely negative strategy for the U.S. Treasury) owing to my expectation that the yen will appreciate substantially in the next 12-24 months. This would more than offset the lower interest rates available. Of course various hedging strategies can compensate for this possibility, but those too have costs and can really only be managed effectively by extremely sophisticated financial service firms.

As for deposit-taking in Japan by American banks, I support efforts to continue removing the formal and informal barriers. Realistically, however, I don't see how American retail banking operations are going to break through the monopoly of the giant Japanese banking institutions with their massive branch networks and vast relationship systems. In fact, statistics seem to show that as the Japanese banking system has been liberalized, American banks have lost what little market share they had in certain fields where foreign banks once had a competitive advantage.

Q.4. Former Secretary of the Treasury Donald Regan and other advocates of the Reagan/Bush economic policies have told this Committee that the growing foreign investment in our economy is not a bad development, but rather is a reflection of the confidence foreigners have in our stable political environment and business climate.

- **Do you agree with that assessment? If not, why not?**

4. Foreign investment in the United States is a double-edged issue. Yes, the fact that foreigners choose to invest here has much to do with their confidence in our economy, which is indeed a tribute to 200 years of successful performance by the U.S. political and business systems. It also has the potential to be very beneficial to the health of our economy. But that doesn't mean we should ignore what almost all foreign investors will gladly volunteer as part of their motives: the bargain prices of our assets in foreign currency terms and the porous nature of our market. Taking advantage of those features, foreign businesses will build global operations and economies of scale that will make them super-competitive with American business on a world basis as well as inside the United States itself.

The issue is not whether foreign investment is good or bad, because it can be either or both. The questions we should be asking are in the specific--Are we surrendering too much control over too many assets in certain areas? What are the long-term implications of loss of American leadership in those areas? and Would it be more prudent to think more carefully and have better balance in those areas between foreign and domestic investment?

Q.5. You mention the necessity for borrowing abroad right now. We recognize that this accumulated borrowing has turned the world's largest creditor nation into the world's largest debtor in less than 10 years.

- **What are the most important dangers of being a debtor nation, in your estimation?**

5. Among the dangers of being a large net debtor nation:

--1) We are clearly no longer able to set as vigorous an agenda with our economic partners and to insist on greater change or speed of change in their systems, because we are reliant on their financial support.

--2) We are allowing our economic system to become exposed to numerous and unpredictable outside financial shocks, on top of the domestic ones which are already bad enough.

--3) We are unable to use financial power as dexterously as we might in the great era of opportunity that lies ahead, especially in playing a leadership role in the rebuilding of Eastern Europe and the Soviet Union. We will ultimately take a back seat in this world-shaking and world-changing process, because we lack the assets to do otherwise.

--4) As foreign interest payments assume a larger and larger portion of the U.S. budget, they are contributing to the "crowding out" of other needed investments and expenses, and thus contributing to the collapse of some of our most important competitive assets--our educational system, our transportation and utility infrastructure, etc.

--5) It is not inconceivable that foreign holders of our debt will at some time in the future attempt to use various threats or pressures to withhold financial support in order to achieve political or economic aims.

--6) We are reaching the upper limits of how much paper debt foreigners want to hold. They will increasingly seek an "asset settlement"--buying our assets, rather than our debt--along with greater denomination of U.S. debts in foreign currencies. With that possibility comes even more prohibitive cost-of-capital problems, great inflationary pressure and fiscal solvency dangers. Large-scale issuing of foreign debt in yen or marks will also imply the demise of the dollar-based world economy. For all the burdens and costs associated with issuing the world's reserve currency, a dollar-based global economy has been a large net asset for American business, and the loss of the dollar's leading role will further erode U.S. competitiveness.

Q.6. **Mr. Burstein on page 27 of your prepared testimony you expressed optimism about America's ability to deal with its competitiveness problem because in your view "America is waking up". Mr. Chimerine, on the other hand, was pessimistic on page 8 of his testimony because our country's unfavorable trends are not receiving adequate attention. Can you each explain in more detail why you are optimistic or pessimistic?**

6. I am optimistic about the prospects for the United States to begin to meaningfully address the competitiveness problem--although I am only cautiously optimistic. The reason for my optimism is that I think the American people are "there" already--they understand that we are losing out in the global economic arena and they intuitively understand the negative implications of that trend. My experience talking to average, ordinary "man-in-the-street" Americans is that they understand issues like the "Japanese challenge" and the loss of America's manufacturing base considerably better than the present Administration does. They have a strong grasp of what it means to be a debtor nation, and have a developing willingness to do something about these problems if there were some leadership to show them what to do.

Increasingly, the nation's "thought-leaders" are presenting the competitiveness problem forthrightly. This includes intellectuals in the media, in academics and in the broad practice of the economics profession as well as private sector corporate leaders at major U.S. enterprises. Elements of the country's elected political leadership are also coming around. All this is very different than the situation three years ago when the problems were mounting and few people even wanted to acknowledge or discuss them.

What is missing, however, is a strong leadership force in Washington to issue a plan and to rally the nation behind it. I suppose I believe that either the present Administration will ultimately respond to this growing American concern about competitiveness, or else it will be supplanted in due course with an Administration that comes to office with competitiveness as its central issue, message, and action-program.

Q.7. An October 1988 publication of the Department of State's Center For The Study Of Foreign Affairs entitled "Japanese Investment In The United States" argues that:

> **"Japanese investment in qualitatively different than other foreign investment in the U.S. because [in part]... Japan is far more closed to American investment than are other countries investing in the U.S."**

- **Do you agree that Japanese foreign investment is in some qualitative way different from investment from other foreign countries?**

7. Japanese investment in the U.S. is quantitatively and qualitatively different than other kinds of foreign investment. And, while I am not at all opposed a priori to Japanese investment, I believe it is somewhat disingenuous of the Japanese and their American lobbyists to try to minimize their role by referring to statistics showing the UK as a bigger foreign investor in the U.S., or asking why no one criticizes the Netherlands for its investment stake, which Japan has only surpassed in recent months.

Here are some of the differences between Japan and other foreign investors:

--1) The rate of Japanese investment is growing much more rapidly than almost all others foreign investors. By the mid-1990s, Japan will almost certainly overtake the UK as the largest foreign direct investor in the U.S. The combination of Japan's direct investment and portfolio investment already makes it the largest foreign investing nation.

--2) British, Canadian, Dutch, Australian, German and other large foreign investors tend to invest in a much more diverse way than the Japanese, with much less concentration at strategic points of the U.S. industrial base and financial system. One does not see the Germans, for example, moving their automotive industry into the U.S. heartland the way the Japanese auto manufacturers are doing, nor does one see British banks with 20%+ market shares of banking assets in major states, as the Japanese banks in California enjoy.

--3) In the public mind, all the above-named foreign investing nations except Japan have a relatively decent reputation for openness in their countries to U.S. investment and trade. I would venture to say that Americans think of Australians, Canadians, Englishmen, etc. as very open people who are much like us. This is not the case, of course, with Japan. I don't want here to argue all the issues involved in these perceptions--facts, myths, changing trends, cultural dynamics, etc. But by and large, the U.S. balance-of-trade is within reason, or even favorable with almost all large foreign investing nations--except Japan. I believe that Americans are not yet so nationalistic or xenophobic as to be opposed in principle to foreign investment. The perception of Japan as an "unfair" trading nation, however, makes Americans particularly sensitive to Japanese investment.

--4) Although the evidence is complicated to assess, I think a reasonable case can be made that the Japanese are less likely to "do as Americans do" when investing in the U.S. than other foreign investors. Most Japanese operations in the U.S. are still run almost exclusively with Japanese nationals as the top decision-makers and executives; Japanese industrial companies in the U.S. tend to import a higher percentage of their parts and components from Japanese sources than other foreigners do from their home country; Japanese companies tend to maintain their Japan-based infrastructure of relationships (suppliers, banks, construction companies and even advertising agencies) with other Japanese companies in the U.S. in a way almost no other investing nation does; Japanese companies have a poorer record than others on issues relating to minority hiring, female managerial promotions and unionized labor representation; and Japanese expatriates running Japanese enterprises in the U.S. tend to set themselves apart from American communities with their own schools, golf courses, high-priced real estate enclaves and other perks that smack of a "neo-colonial" mindset. All of these factors contribute to the different way in which Japanese investors are perceived as opposed to other foreign investors.

--5). On a more inchoate level, I believe the majority of Americans feel we know what the limits of British, Canadian, Dutch--and even German--power are in the the modern world (although perceptions of the German question may be changing). These countries don't and can't threaten us. Even with all America's competitiveness problems, our economy is still far more competitive and in far better shape than Britain's or Canada's or Australia's. We don't, however, know what the limits of Japanese power are and Japan can pose a threatening image--economically and in other ways.

--6). Undeniably, there are elements of racism and culture-ism in the American attitude of mistrust and suspicion towards the Japanese which are not present in our attitudes towards Anglo-Saxon and European investing nations. We must acknowledge this if we are to have any frank discussion of the problem. But apart from knee-jerk negative reactions to the Japanese, there are some legitimate fears about Japanese culture because its values are so different from American values. I believe that at least one reason Americans react more negatively to Mitsubishi Estate buying a major interest in Rockefeller Center than to Olympia & York owning vast tracts of of Manhattan's financial district is that Americans correctly perceive that the world is being Japan-ized, not Canadian-ized, and that if the Japan-izing process continues, they fear a loss of personal freedom and a less democratic environment than the value system we have grown up with.

--7). There are also undeniable facts of history from 40-50 years ago that still exert a major force. As far as the British, Dutch, Canadians and Australians go, they were all on our side in the last war. Many Americans--including senior leaders in business in government--still have at least part of their consciousness about Japan shaped by wartime memories. As for Germany, I do not think I will get an argument from the scholars if I assert that the Germans have done more to consciously redress the atrocities of their recent history than the Japanese have. In my interviews with business leaders in Germany, I frequently finding them saying things like "We understand why the rest of the world still has suspicions about a more powerful Germany, even though we think those suspicions are unfounded today." In Japan, conversely, I hear business leaders assert that it is simply wrong and unfair for anyone to mistrust Japan's motives or intentions. Hints and glints of the kind of fanaticism that existed in such abundance in both Germany and Japan five decades ago can still be seen in both countries today, but much more frequently in Japan.

Q.8. **As you know many Americans are increasingly concerned over rapidly increasing ownership of U.S. assets. Can you explain to us in a clear and concise fashion how increasing foreign ownership of America's assets is, in your view, related to our budget deficits?**

8. The budget deficit is a symptom of the erosion in our capital-formation and domestic capital-generation. It is a symptom of our evolution as a debtor nation. As I have indicated above, foreign investors are increasingly uncomfortable holding the paper debt of the U.S. government or investing exclusively in Treasury bonds as was the Japanese habit several years ago. Any good financial adviser would tell them to diversify out of bonds into hard assets. This is what is happening now.

Q.9. **You state on page 16 of your prepared statement that the Reagan Administration's belated 1985 attempt to drive down the value of the dollar in order to reduce our trade deficit with Japan:**

> **"proved to be an economist's ivory tower fantasy vision of the free market completely divorced form how trade takes place in the real world."**

- **Why wouldn't driving down the value of the dollar and making Japanese goods more expensive here, and American goods cheaper in Japan help reverse our trade deficit with Japan?**

9. Driving the dollar down did not translate into making Japanese goods more expensive in the U.S. as it should have in "pure" economic theory for a number of reasons:

--1). The Japanese, always obsessive about maintaining market share, preferred to keep their dollar prices as level as possible in the U.S. market--even if that meant lower profits or even losses--in order to maintain market share. The size and scale of Japanese companies have a lot to do with their ability to sustain such losses, but so does their long-term vision and their lack of need to respond to short-term stock market pressures. If you track the changing dollar prices of Japanese exporters against the changing value of the dollar, you see that many of them held out a year or even two years into the dollar devaluation before changing their prices at all. When they did raise prices, they tended to raise them far less than the change in currency rates--never the direct 1:1 correspondence the economists had predicted.

--2) The Japanese responded to the challenge of a strong yen by restructuring their industry. The period from 1985-7 when the dollar was falling and the yen was rising was a time of massive Japanese rationalization. They moved labor-intensive industries offshore, invested in new technology, shifted employment patterns, retrained workers, entered new businesses, etc. By 1988, for all intents and purposes, the Japanese could once again compete effectively at the same dollar export prices as before, despite the massive currency realignment.

--3) The economists forgot to "model in" the fact that Japanese export goods in this country had become "prestige" products bought for their quality, not for their price. Thus even when Japanese prices went up a bit, Americans were still willing to pay for what they perceived as quality-leadership in Japanese products.

--4) Similarly, the model didn't account for how many Japanese products had no domestic U.S. competition--fax machines, VCRs, a broad range of computer chips, high-quality/low-priced cars--these things are not made by U.S. companies anymore. In some of these areas the Japanese could afford to pass on price increases to U.S. consumers without losing market share because no American companies could possibly capitalize on the opportunity.

--5) In areas where American companies did have competitive product offerings (especially automobiles, which lies at the heart of the trade deficit), the American companies tended to see rising Japanese prices as a chance to raise their own prices and reap higher profits. That is one reason why after a massive currency realignment, GM's market share in the domestic U.S. market is still falling to record lows, and why Chrysler is teetering on the brink of disaster.

--6) The strong yen allowed Japanese companies to achieve massive cost savings in oil and other imported raw materials which are denominated in dollars and which they must import. This made it easier for the Japanese exporters to keep their U.S. prices relatively steady. Similarly, when Japanese businesses moved offshore in response to the strong yen, they tended to move to dollar-linked areas: Korea, Taiwan, Hong Kong, Singapore --and the U.S. itself. The more the dollar fell, the cheaper the labor in all these places became in yen terms, and the easier for the Japanese to compete more effectively than ever.

On the other side of this equation, U.S. companies trying to sell their products in Japan did not enjoy the benefits predicted by the economists from cheaper pricing owing to a weaker dollar for some of the following reasons:

--1) The Japanese distribution system continued to mark the American products up to prior levels and simply gain greater profit as a result of the lower prices. Since few American companies trying to do business in Japan have their own direct lines of access to the market (owing to the nature of the Japanese distribution system), this syndrome had a huge effect.

--2) The economists did not "model in" the fact that Japanese consumers are not as price-sensitive as American consumers. They don't buy something because it is a bargain. In their culture, something cheaply priced is probably not very good. Indeed, among the biggest foreign beneficiaries of the strong yen and the Japanese consumer boom were high-priced European fashion products and automobiles perceived in Japan as the most expensive--and therefore, the best.

--3) The economists also failed to "model in" the Japanese cultural reluctance to buy foreign goods and cultural willingness to buy Japanese goods even if they are more expensive.

--4) The higher costs of doing business in Japan after the dollar's fall prevented many American companies from opening offices, sending expatriate personnel, investing in advertising and marketing and other essential elements to building an effective presence in Japan.

--5) Some areas where U.S. exporters could have made much bigger, quicker gains on the strength of lower prices--such as agricultural products--are still heavily regulated and even closed to foreign participation in Japan's economy.

Overall, the most important error the economists made was in not foreseeing that the strong yen/weak dollar equation would make Japan the world's leading financial nation, and make it so easy for Japanese business to invest all over the world, to buy the assets they had previously lacked, to build their factories right inside the American marketplace, etc. This will be the most important issue going forward in terms of the effect of the currency realignment on the continuing erosion of U.S. competitiveness and the further development of Japanese "super-competitiveness."

Q.10. It has been argued that one of the reasons that the Japanese cost of capital is so low is because the Japanese consumer is prevented form borrowing. Consequently, more capital is available for industry (and government) use. Japan's investment, productivity, and competitiveness increase correspondingly.

- **Do you agree with this analysis?**
- **If so what can we do about it?**

10. The low level of Japanese consumer debt (and conversely, the high level of Japanese personal savings) figure heavily in the low cost-of-capital structure in Japan, just as the opposite is true in the United States. It is silly for us to put ourselves in the position of insisting that Japanese become more profligate to redress this imbalance, as our negotiators have often done. This imbalance must be redressed by domestic American action to raise our savings rate and lower the cost of capital in this country.

Q.11. How much comfort can we take from the fact that, unlike Third World debtors, our foreign debt is denominated in our own currency?

11. We can take tremendous comfort from the fact that our debts are mostly denominated in our own currency. If they weren't, we would be in a position not unlike third world debtors. As I have discussed above, however, there will be increasing pressure for us to denominate more debt in foreign currencies, especially in yen, if we don't reduce our deficit.

America is a powerful, strong country with enormous assets. We can continue for several more years consuming the wealth our parents and grandparents and great grandparents built up in this country. In a philosophical sense, however, we should be clear: When the world takes our IOUs in U.S. dollar paper, it is not a tribute to us--as some in the Reagan and Bush Administrations would have it. In reality, it is a tribute to prior generations of Americans--the incredible wealth they accumulated, the vast productive machinery they established and the unprecedented stability of the economic and political system they achieved. These institutions are so strong that despite our horrifying record at systematically undermining them in the 1980s, they remain among the strongest in the world.

I do not believe, however, that we can go on forever this way. There will come a point when Japan, and perhaps Germany, will inspire more economic and institutional confidence globally, and the yen and the mark or the ECU will be what the world wants to have and to hold.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE
PROFESSOR KLEIN

Q.1. Professor Benjamin Friedman of Harvard, who appeared before the Banking Committee on November 14, stated the following in his book Day of Reckoning, a book upon which much of his testimony was based. Let me quote:

> **"World power and influence have historically accrued to creditor nations. It is not coincidental that America emerged as a world power simultaneously with our transformation from a debtor nation dependent on foreign capital for our initial industrialization to a creditor supplying investment capital to the rest of the world. But we are now a debtor nation again and our future role in world affairs is in question...America's influence over nations and events will ebb."**

- **Do you agree with that analysis? Please explain why or why not.**

Q1. I do not believe that America's influence over other nations will ebb as a consequence of our becoming a debtor nation. I must note, however, that I do expect that we will share more power in the world with European and Far Eastern nations, but that sharing has been growing for a long time and is a natural outcome of the recovery and expansion of other nations that is not rooted in our debtor status.

Also, I think that power and influence do not wholly derive from economic bases. These attributes depend on military strength, population dynamics, cultural developments, and creativity. We have not lost our non economic powers and are not about to do so. Our economic lapse is temporary or cyclical. We shall eventually put the problems of debtor status behind us.

Q.2. As you know many Americans are very concerned about rapidly increasing foreign ownership of U.S. assets. Can you tell us whether you believe that such ownership is directly related to our budget and trade deficits?

- **If so can you explain how these factors are directly interrelated?**

Q2. International trade and international capital flows travel along 2-way streets. We invest a great deal abroad. This has been going on for a long time and we continue to invest abroad. We ought not to try to barricade our shores to foreign investors who want to own some American assets. It goes without saying that certain areas of strategic control are off limits to foreign investors.

Of course, foreign ownership of US assets is closely related to our budget and trade deficits. In the first place, our trade deficit must be covered by a corresponding capital inflow from abroad. Much of this inflow will be directed towards asset accumulation. Also, we must market our public debt to cover our budget deficit. As long as political decision makers are not willing to force Americans to take up the deficit (as through taxation or reduced spending or both), someone has to purchase the debt, short of our monetizing it (which would be a silly alternative) and we have no place to turn except to foreigners, who then create a capital inflow.

Q.3. Professor Friedman of Harvard in the prepared testimony he presented to the Committee on November 14 said that the reason the dollar has not fallen to the level needed to bring U.S. exports and imports into balance is because foreigners are now using their dollars to buy up U.S. assets. When foreigners have all the U.S. assets they want, he said, the dollar will fall to the level needed to correct the trade imbalance.

- **Do you agree with that analysis.**

Q3. I agree that foreign purchase of US assets creates a capital inflow that keeps up the demand for and exchange value of the dollar. All the inflow is not directed at asset accumulation; much of it comes on loan, through the purchase of US debt instruments. Also Federal Reserve policy, commodity price movements, and foreign monetary policy all affect the dollar's value. It is not appropriate to imply that foreign purchases of US assets is, by itself, keeping up the dollar's value.

Q.4. Former Secretary of the Treasury Donald Regan and other advocates of the Reagan/Bush economic policies have told this Committee that the growing foreign investment in our economy is not a bad development, but rather is a reflection of the confidence foreigners have in our stable political environment and business climate.

- **Do you agree with that assessment? If not, why not?**

Q4. True enough, foreigners are willing to buy and hold US assets. This will not go on forever -- certainly not at present interest or yield levels. We are in a vulnerable position; so we cannot simply rest assured that foreigners are providing a vote of confidence for our economy.

Q.5. **Mr. Burstein, a journalist/author who appeared before our Committee on November 14, stated that we have a competitiveness deficit not just a trade deficit with Japan. He stated:**

> **"our competitiveness deficit here derives from a combination of our low savings rate, the drainage of capital out of our system in the form of a trade deficit, the high U.S. government budget deficit and high corporate borrowing demand."**

- **Do you agree with Mr. Burstein?**

Q5. It is an expression of crude mercantilism to focus on our bilateral deficit with Japan. Our multilateral or overall deficit is what matters. Our deficit with Japan and our overall deficit are both undergoing change and will not last indefinitely. This is a projection, not a value judgment. I do agree, however, that we should improve our competitiveness. We can do so and probably will do so.

The reasons cited by Mr. Burstein for our lack of competitiveness are only partial. They are relevant, but do not account for some of the main factors.

Q.6. **Mr. Burstein also stated in his November 14 prepared testimony that:**

> **The U.S. trade deficit is now being compounded by the even worse current account deficit, and this will become a bigger problem over time as Japanese companies begin to repatriate their profits from the American market causing another major drain of dollars out of the system."**

- **Do you agree with Mr. Burstein's contention?**
- **What are the future implications of this development?**

Q6. Our deficit on goods and services account in the national income statistics has improved significantly and may continue to do so. Our current account deficit is still very large, mainly because of US government interest payments abroad. Easier monetary policy, both absolutely and by way of accommodating fiscal prudence, could do much to bring down the current account deficit.

Q.7. **Dr. Lawrence Chimerine, another witness at our November 14 hearing, told us that many American families, in order to compensate for a dramatic slowdown in the productivity growth of our economy and a stagnation in the growth of real wages, have gotten along by relying on second incomes and by cutting savings and\or going deeper into debt in order to maintain living standards.**

- **Do you think that we are now at the stage that unless we deal with our productivity problem, the real standard of living of Americans will begin to decline.**

Q7. I agree that productivity improvement is the most basic and significant thing that we could do to improve competitiveness and preserve living standards in America. Our standards are not likely to decline in an absolute sense but could do so in comparison with some other nations.

Q.8. **Dr. Chimerine, also told us that our highest national economic priority should be to improve economic productivity. Among the steps he advocated for doing so were:**

1. **reduce the budget deficit;**
2. **raise private savings;**
3. **channel savings to productive investment in manufacturing;**
4. **raise non-defense R&D; and**
5. **improve the quality of education.**

- **Do you agree that our highest national economic priority must be to improve our national productivity and that the steps outlined are the right ones. Would you add any?**

Q8. Dr. Chimerine has cited the most important things to do to improve productivity, and I agree that this goal merits highest national economic priority. Of all your citations of comments by others, this comment by Dr. Chimerine is the one to which I can relate most closely. I might add one step -- explicitly join the world movement towards disarmament and foster the acceleration of such an international movement.

RESPONSE TO WRITTEN QUESTION OF SENATOR PRESSLER
FROM PROFESSOR KLEIN

Q.1. What effect would it have on the U.S. economy if we were to raise taxes – individual corporate rates or adopt a consumption tax such as VAT.

A tax rate is definitely called for in order to help reduce the federal budget deficit. Some help should come from the side of expenditures, preferably through reductions in defense spending to match those offered by Secretary Gorbachev, and some help should come from the side of revenues through a tax increase. I would personally prefer to see a return towards more progressivity i.e. through raising the rate of personal taxation at the top.

A VAT, with differential rates for luxury-type and sin-type goods would be a second choice. A stiff tax confined to gasoline or imported crude is another revenue raising avenue that would simultaneously help our trade balance by cutting back on oil consumption, too much of which is imported.

I am not particularly in favor of raising corporate rates at this time. Tax reform did not help business capital formation, and I would not like to increase business tax burdens at this time. In fact, the 1986 tax reform legislation made serious mistakes in taking away incentives for business capital formation.

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